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India
Note on Financial Accountability Systems of Selected State Level Power Sector Entities

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CURRENCY EQUIVALENTS

Currency Unit	=	Indian Rupee (Rs.)
US$1	=	approx. Rs. 46
1 Crore	=	10 million
Rs. 1000 Crores	=	approx. US$217 million

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ACKNOWLEDGEMENTS

The World Bank has conducted a study on Financial Accountability Systems of State Power Sector Entities relating to a selected number of states. This report was prepared and finalized by Vinod Sahgal, Regional Public Financial Accountability Specialist and Manoj Jain, Senior Financial Management Specialist, of South Asia Region Financial Management Group of the World Bank. A team of consultants from Ernst and Young led by Ram Sarvepalli undertook the supporting background and analytical work.

The study was carried out with the help of a survey of stakeholders of various entities under review (director finance, statutory auditors, internal auditors, members of the audit committee) and regulators and energy secretaries of the respective states. The study was conducted through a process of review and analysis of publicly available material and financial statements, surveys, interviews and discussions with the relevant stakeholders in the state level sector entities.

The study was conducted with approval from the Government of India (Department of Economic Affairs) in respect of the states where the World Bank has been engaged in the Power Sector.

We gratefully acknowledge the extensive contributions of each official and coordinator in the various power sector entities for their valuable assistance in facilitating this study. Constructive suggestions were provided by Robert J. Saum and Ivor Beazley of SARFM. The report also benefited immensely from comments received from Salman Zaheer, Judith Plummer, Rohit Mittal, Rajesh Sinha, Ismaila Ceesay, Ashok Haldia, S.L. Rao, Suresh Prabhu, K.S. Menon and Dharitri Panda and earlier from Bhavna Bhatia. Sheela Bajaj edited the report. Many thanks are also due to Seema Sachdev, Rashmi Goel, Neetu Sharda and Vinaya V. Vemuri for their efficient technical and administrative support.

TABLE OF CONTENTS

TABLE OF CONTENTS

CONTENTS **PAGE**

ABBREVIATIONS AND ACRONYMS

AAS	Auditing and Assurance Standard
ADB	Asian Development Bank
AG	Accountant General
APDRP	Accelerated Power Development and Reform Program
ARR	Annual Revenue Requirement
AS	Accounting Standard
C&AG	Comptroller and Auditor General
CAS	Country Assistance Strategy
CEO	Chief Executive Officer
CESC	Calcutta Electricity Supply Corporation
CFO	Chief Financial Officer
CMD	Chief Managing Director
CPSU	Central Public Sector Undertaking
Cos Act, 1956	Companies Act, 1956
DFID	Department for International Development
ESA 1948	Electricity Supply Act, 1948
ESAAR 1985	Electricity Supply Annual Account Rules, 1985
ICAI	Institute of Chartered Accountants of India
ICWAI	Institute of Cost and Works Accountants of India
IGAAP	Indian Generally Accepted Accounting Principles
IUT	Inter-Unit Accounts
MIS	Management Information System
MoA	Memorandum of Agreement
MoP	Ministry of Power
MoU	Memorandum of Understanding
NHPC	National Hydroelectric Power Corporation
NTPC	National Thermal Power Corporation
OECD	Organization for Economic Cooperation and Development
PLF	Plant Load Factor
SEBI	Securities Exchange Board of India
SEBs	State Electricity Boards
SERCs	State Electricity Regulatory Commissions
T&D	Transmission and Distribution

EXECUTIVE SUMMARY

Background

1. The power sector in India has witnessed a large number of initiatives that focus on operational issues, including aspects of financial management and accountability, relating to the sector's performance at both central and state levels. Despite improvements such as timely accounting of transactions and preparation of financial statements, the strengthening of primary institutions for financial accountability has not kept pace. The reliability of financial information provided by power sector bodies at the state level has been of concern to government and other stakeholders, including potential investors. Thus, there are concerns regarding the quality of accounting, internal control, auditing, reporting and internal and external scrutiny arrangements. The new Electricity Act, 2003 has created a base for the sector's growth. However, considering the challenges involved and the lengthy period over which benefits would accrue, fresh effort is necessary to further institutionalize governance and financial accountability arrangements.

2. Given the sector's inheritance of distorted tariffs, theft, political patronage, static skill sets and poor information systems, the challenges were and still are significant. Nevertheless, the corrective steps taken by some entities are encouraging, given the complexities and constraints that these entities have inherited from the erstwhile SEB era. What matters most is strengthening of the management structure for effective monitoring of performance. A key aspect in performance monitoring and operational transparency is strengthening the financial reporting framework including financial accountability. Moreover, as this sector receives major state subsidies, a sound and transparent system is imperative for financial accountability and governance. This is critical for building investor and public confidence. The study therefore aims at assessing the primary financial accountability systems of state power entities.

Scope and Approach

3. The study examines and highlights systemic issues of accounting, financial reporting, auditing, disclosure practices as well as capacity and policy gaps in state power sector entities. Sustainable recommendations have been developed to remove roadblocks and strengthen financial management, reporting and disclosure practices.

4. Review and analysis of public material, financial statements, surveys and discussions with stakeholders have been used to understand operational practices and to report on the level of subsidies and return on investment. Finally, the study focuses on consensus building with stakeholders on key issues and solutions.

5. The purpose of the recommendations is to advise the Bank and stakeholders, feeding into the Country Assistance Strategy (CAS), on the quality of corporate governance, reporting and management answerability for public investment [1] in the power sector.

[1] Additional work would be required to implement some of the suggestions made in this study.

6. The Bank began stepping up its involvement in reform associated with the power sector with the Jaipur Conclave of 1993. Since then, it has supported state-level initiatives, under the Loan Program and provided technical assistance alongside related dialogue in Orissa, Andhra Pradesh, Karnataka, Uttar Pradesh, Haryana, Rajasthan, Tamil Nadu and Punjab. Progress has been mixed, with the increasing realization that institutional change and capacity building for sound corporate governance need long-term measures.

Observations

7. Further improvement in corporate governance of the state power sector is a central issue. For this, new incentives to build institutional capacity for financial management and accountability are essential. Improvements in accounting and control systems have been introduced in several entities from 2001 in particular. These have included unbundling of state electricity boards (SEBs) and strengthening the accounting and information systems in states such as Rajasthan and Andhra Pradesh. The staff of the entities is commended for the effort made to strengthen financial accountability. However, the pace of improvement in these and other states and in related areas needs further attention[2] with strong leadership. These areas include accounting for fixed assets, receivables and pension liabilities for past services. In some cases, only the symptoms of the malaise concerning reliable information are being treated. The time has come to look at the root of the problem. Merely unbundling is not sufficient: the unbundled entities need greater autonomy with independent directors, stronger professional management, greater recognition of the role of financial management in corporate governance, heightened government scrutiny, and all transactions fully disclosed in the annual financial statements. Most importantly, a modern Management Information System (MIS) with a common operational framework for all entities is essential. This is achievable as India has the technology for transforming legacy systems to integrated systems in line with the best international practice.

8. **Accounting and Internal Control:** Presently, financial statements do not provide a strong basis for comparing financial performance across entities and states over time. The study reveals that most entities (72percent) follow a combination of accounting policies laid down by the Indian Generally Accepted Accounting Principles (IGAAP) and those recommended by the Electricity Supply Annual Account Rules (ESAAR), 1985, historically applicable to SEBs. There is no consistency in accounting policies despite legal clarification and transition from ESSAR, 1985 making inter-company comparison difficult. The transition in accounting practice during the reforms has been uneven with unspecified timeframes.

9. Additionally, there is delayed disclosure of financial statements, insufficient presentation and absence of related decision-making. On the average, the time taken for annual book closure was approximately 22 months from the end of the financial year to sign off by the auditors. These delays constitute a violation of Sections 166 and 210 of the Companies Act, 1956 and Rule 4 of ESAAR, which require companies to submit their audited accounts within six months of the end of the financial year.

[2] A.K. Sachan, Secretary, Central Electricity Regulatory Commission, *The Economic Times,* May 10, 2005: " Mere unbundling and restructuring of vertically integrated monopolies does not guarantee the desired efficiency improvements. Functional autonomy to the management and their accountability hold the key to a vibrant sector."

10. In this scenario, the quality of management is the key factor for the growth and operation of effective financial management and accountability. To achieve this, basic skill sets should be given due priority and brought in line with modern management standards of the private sector.

11. **Internal Audit:** The internal audit function exists in most entities but is largely ineffective. Presently, the financial side of internal audit is better developed than the operational and technical side, that is, energy audit. The primary activities of internal audit therefore relate to compliance with internal financial policies and procedures governing financial transactions rather than operational efficiencies. The reports generated are voluminous, as they focus on individual transactions rather than systems and practices. As a result, senior management follow-up is limited. But this is difficult to demonstrate given that there are reportedly large transmission and distribution (T&D) losses across the sector. In fact, this function does not advise the management on improving operating efficiency. The lack of governing principles and practices on internal audit by any national authority is also a significant support gap. The recent emphasis on energy audit is a healthy feature but there are limitations to its effectiveness, given the infrastructure and information reliability concerns. Overall, there is no visible linkage between the operations of the internal audit function and its impact. One reason may be the lack of independence of the function; absence of internal auditing standards is another. In most cases, the internal audit function reports to the finance director and not to the head of the entity. There is also a perception of conflict of interest and internal audit reports do not always reach the board or the audit committee.

12. **External Audit:** The process of appointing external auditors also needs revision. The choice of auditor can be made more transparent in order to: (i) obtain the required audit capability; and (b) provide a minimum level of fees based on the size of the entity. Audit reports can be deficient.[3] Adverse audit opinions are not provided even when there are significant deficiencies in the accounts. None of the entities looked at had a clean report from the auditor over a three-year period. These external audits are conducted by: (a) the statutory auditor recommended by the Comptroller and Auditor General (C&AG); and (ii) by the C&AG as a supplemental audit to review the work of the statutory auditor. Often, the qualifications reported by the statutory auditor in the audit report and the accompanying "true and fair view", prima facie, appeared contradictory. The qualifications usually pertain to areas such as incomplete or unavailable records, subsidy receivable, incorrect or incomplete opening balances, and weaknesses in internal control. While there are significant accounting deficiencies uncovered by audit, the concept of materiality is unclear, resulting at times in the audit reports being loaded with trivial issues that could negate the impact and importance of management and reporting. The repetitive nature of qualifications is another feature, diluting the management's responsibility towards audit reports and provision of reliable financial information. It thus leaves many

[3] Auditors often issue "subject to/except for" audit opinions with a list of observations in apparent violation of national standards. Some audit reports often contain a "subject to/except for" audit opinion with a long list of audit observations which may either appear in the audit report or in notes to accounts or in an annexure, the cumulative effect of which may be material enough to warrant issuance of "an adverse or disclaimer" opinion. The auditors of such power sector entities often give an appearance of trying to convey a message to the reader without appropriately qualifying their audit opinion. The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India (AASB) statement on qualifications in auditor's report requires the auditor to consider the collective effect of all the qualifications taken together in preparing an audit opinion on "true and fair view," such as the case might substantially affect profit or loss of the company.

stakeholders confused on the full impact of audit and the true financial position of the entities. It also raises doubts on the validity of the auditor's opinion since material distortions do not lead to an adverse opinion. Furthermore, the supplementary audit done by the C&AG does not have any standard form to clarify whether the opinion given in the statutory auditor's report is qualified, adverse or a disclaimer.[4]

13. **Audit Committee:** An effective audit committee can be a powerful instrument for public financial accountability. Though nearly 80 percent of the entities reviewed as part of this exercise have formed audit committees, their managements do not see any important role for such independent supervision and governance, thereby making the formation of audit committees a mere statutory compliance. The roles and powers of the audit committees across entities have not been clearly defined, with most comprising existing operational directors of the board. This adversely impacts their effectiveness and independent supervision. Also, despite the need for understanding business issues and their impact on financial well-being, most audit committees do not have members qualified to scrutinize the work of the external and internal auditors. Neither are they able to question the assertions of management relating to the stated financial position or the quality of internal control. Audit committees have thus not explored the causes of the lack of reliable information and have also not effectively monitored the reduction of T&D losses. Clearly, audit committees exist today more in form than substance.

14. **Regulatory Reporting:** The regulators have demonstrated tremendous patience with the quality and timeliness of reporting on financial performance and cost information for tariff setting provided by the licensees. The regulators have also periodically expressed serious concern about the reliability of information provided. This affects the accuracy of tariff setting and subsidy allocations. The risk of utility inefficiencies is thereby passed on to the consumer, and subsidies do not reach the intended recipients. The regulators have also expressed the need to: (a) infuse the requisite skill sets into their own organizations to enable adequate study; and (b) enable direct licensees improve their reporting. The need for high- quality professional support to the regulators from the accounting profession (apart from support to the utilities) is the call of the day.

Recommendations

15. The study suggests that the way forward entails three thrust areas. First, corporate governance must be strengthened by appointing independent directors in line with greater autonomy. Second, the MIS must integrate technical and financial information to strengthen the efficiency of the system. Finally, a program for capacity building across the sector should enable these entities to implement reforms and system-wide improvement. These areas are now brought to the attention of Government and senior management of the respective entities.

16. Against this backdrop, three cross-cutting issues emerge: (a) human resource management, including skill sets and training; (b) manuals and codes, including a chart of accounts aimed at a

[4] There is also a need to review the existing practices of C&AG audit under Section 619 of the Companies Act, 1956 (as most electricity companies are government owned) in order to see that audit is being done strictly in conformity with statutory provisions.

common framework for accounting and internal control; and (c) incentives to speed up the process of reforms across the sector.

17. The study makes a number of recommendations aimed at capacity building and institutional reforms in governance and accountability. Policy dialogue on the range of issues raised is encouraged with the power sector entities, state and central governments, regulators and the accounting and auditing profession. There is need to further step up dialogue with the key stakeholders.

18. **Dialogue with power sector entities:**

- Clean audit opinion over a period
- Annual reconciliation of accounts with the state government
- Transactions with related parties disclosed
- Investments in an integrated accounting system and identifying sources for these resources.
- Active and operational audit committee
- Incorporation of operational tools for improved financial reporting
- Disclosure of monetary impact of T&D losses

19. **Dialogue with state governments:**

- Development of a "Customer Service Charter" as an upfront agreement between the state and the utility's management on performance, assistance and autonomy.
- Hiring of relevant skill sets to enable power sector entities to acquire appropriate financial management professionals[5].
- Monitoring of progress.

20. **Dialogue with central government:**

- Application of appropriate common principles of governance and accountability
- Design of new incentive mechanisms such as having a separate fund for accelerating financial management improvements.
- Clarification on statute relating to accounting policies – Electricity Act, 2003
- Chart of accounts

21. **Dialogue with regulators:**

- Timeliness and quality of audited financial statements
- Limited review of ARR filing actuals
- Laying down of improvement road map and its monitoring

[5] Hiring is an entity wide problem across States – some of which have had a recruitment ban for several years. Another problem is that large number of staff approaching retirement age and the loss of skills which will occur when they retire.

22. **Dialogue with accounting and auditing profession:**

- Choice of auditors
- Classification of audit opinions
- Disclosure on standards of auditing and scope of audit
- Prioritization based on materiality of qualifications
- Performance evaluation of auditors and adequacy of audit fee structure.
- Training of C&AG auditors in the supervision of modern "attest" auditing

The Ministry of Power provided comments on the Note to the Ministry of Finance on 19th April 2006. These were forwarded to us on 11th May, 2006 by the Dept. of Economic Affairs. The Government's comments and our response thereon is provided below:

Government's Comments

"While the Policy Note has definitely suggested a way forward, the Dept. of Economic Affairs should keep in view that these dialogues with stakeholders will be a long drawn process. It is not clear from the recommendations as to which entity would guide and facilitate the dialogues and consequential actions. A dedicated coordinating systems/structure to conduct & conclude the dialogues and evolve a time bound action program will be required to be identified /set up. The same structure can take up the task of development of performance indicators, operational plan and monitoring the progress of implementation. This structure should involve professionals with required skill set and should be given the control over deciding the incentives based on achievements."

Bank's Response

The Ministry of Power should take the lead for guiding and facilitating the dialogue and consequential actions. In this regard the Ministry of Finance and the Ministry of Company Affairs along with the Comptroller and Auditor General are among the key stakeholders at the Union government level.

Conclusion

23. A corporate governance code for the sector is necessary wherein sound financial information is central. Traditionally, the sector's senior management has emphasized the technical aspects of operational performance rather than governance, financial control and accountability. This bias has led to a high-risk situation where waste of public funds can be widespread. The study confirms that certain significant aspects of the financial information provided by the state power sector entities are unreliable. This has implications concerning the states' fiscal situation. There is, firstly, the difficulty in assessing the states' liabilities on account of power entity operations. Thus, secondly, while the reported profit based on the financial statements of 25 state entities including two electricity boards is substantial, audit qualifications on the subsidy receivable from the state governments point to the likelihood of a substantially changed scenario.

24. The state power sector has been transiting with difficulty from a government dominated administrative style of operation to a commercial mode. This has been induced by legislative

changes in the late 1990s. However, there are other reasons for the continuing weak performance of power sector entities: (i) lack of reliable management information including a common framework and chart of accounts for financial accounting; (ii) poor internal and external accountability systems; and (iii) weak monitoring and evaluation. This impacts decision making within these organizations and related bodies such as regulators. The recently introduced financial accountability institutions such as audit committees of the board, internal audit (including energy audit), external audit, and regulatory supervision are either ineffective or weak. Efforts are required to build a strong foundation for financial transactions and regular monitoring controls. Even modest improvement in efficiency through better financial information and improved internal control would yield rich dividends, significantly reducing the call on state government resources. Reforms are overdue: corporate governance needs strengthening. Fresh blood from the accounting and auditing profession may be needed to strengthen the capacity of power sector entities and enhance their performance.

I. BACKGROUND AND APPROACH

1. The importance of the reliability of financial information provided by power sector entities in India was first raised by S.L. Rao, the author of *Governing Power*[6]. This is a key consideration in investment decisions given the large capital investments involved, continuing government subsidies and high recurring technical and financial losses. The regulator determines the tariff on the basis of filings by the entities, based on their books of accounts. Any mis-statement or unreliable information has adverse repercussions, such as incorrect tariffs, which must be borne by the consumer. Financial information is the basis of decision-making for a variety of stakeholders such as: regulators while levying tariffs; state governments in the case of subsidies; central governments in the formulation of policies and reforms; and banks and financial institutions for evaluating the possibility of disbursing loans. From a governance perspective, reliable financial information is thus crucial not only in decision-making but also control, transparency and accountability. It is one of the principal responsibilities of the chief executive officer (CEO) and ultimately the board of directors.

2. While efforts are under way in many states to introduce sound financial management and improve accountability, a baseline evaluation is worthwhile prior to commencement of the reform process. The electricity utilities have operated as state government departments and not as autonomous corporate entities, unlike their private sector counterparts, which also come within the purview of the Companies Act, 1956. Engineer-run public undertakings have focused on investment in utility assets rather than performance evaluation, return on investment and economic merit. Factors such as consumer service, MIS, financial management and supervision have not received high priority. Prior to the commencement of reforms, the position of these utilities was:

- Distorted tariffs[7]: low relative to costs.
- Subsidies: no financial discipline; heavy government subsidies.
- Power theft and large outstandings: poor internal control systems, enabling widespread consumer and employee fraud; technical and commercial losses form 40-50 percent of electricity generated[8] in most Indian states; SEBs unable to install effective metering or disconnect non-paying customers' meters – arising from poor internal governance.
- Patronage and political interference: political mis-use for patronage in employment, undermining the management's control over labor, making it vulnerable to interference in investment and procurement.
- Civil service employment practices: limited management authority over employees who are generally covered by public service rules and protected by politically influential unions; management cadres, usually recruited from the civil service, tied to government departments with little autonomy.
- Skill shortages: management strongly engineering-oriented, lacking critical commercial skills (financial control, accounting, auditing, economics, human resources management).

[6] Published by TERI Press S L Rao 2004 ISBN 81-7993-033-5

[7] See *A Strategy for Sustained Reform in the State Power Sectors,* South Asia Energy and Infrastructure Unit, The World Bank, September 2003.

[8] *India Country Assistance Strategy*, The World Bank, September 2004.

- Distorted demand: power supply inadequate to meet demand, given the low levels of efficiency and pricing.
- Poor information: no SEB investment in reliable information systems, operating data, consumer metering and financial management and reporting; systems and records largely manual with virtually no computerization; hence, much data remains in manual registers, scattered across the state, unavailable for analysis and strategic decision-making; regarding assets, as the number of units in these utilities grow, their records remain untransferred such that assets relating to particular units lie in completely unrelated units; besides, with no asset register maintenance, collation of asset details for SEBs was never a focus area.

3. The Bank began stepping up its involvement in the state power sector reform process with the Jaipur Conclave of 1993. Since then it has supported state-level initiatives, under the Loan Program and provided technical assistance alongside dialogue, in Orissa, Andhra Pradesh, Karnataka, Uttar Pradesh, Haryana, Rajasthan, Tamil Nadu and Punjab. Progress has been mixed, with the increasing realization that institutional change and capacity building for sound corporate governance need long-term measures.

4. During the reform process, a number of steps have been taken. These include unbundling of the SEBs into generation, transmission and distribution entities to make the sector commercially viable and accountable, given the enormous subsidies received. Orissa, Haryana and Andhra Pradesh were the first to embark on the unbundling path. Other important initiatives taken by the central and state governments included: introduction of the new Electricity Act, 2003; repeal of the Electricity Act, 1910, the Electricity Supply Act, 1948 and the Electricity Regulatory Act, 1998; delicensing of the generation sector; the APDRP; reducing the fiscal strain on state governments; and attracting private investment.

5. Additionally, State Electricity Regulatory Commissions (SERCs) were created in part for pressurizing the entities to improve the availability and quality of financial information. The Institute of Chartered Accountants of India (ICAI) also took steps to improve the form and content of accounting and financial reporting. It recommended that power entities develop general purpose financial statements on the IGAAP basis for uniformity in accounting and disclosure. However, these principles and related practices lacked unqualified legal backing and were usually not interpreted consistently, given the lack of both readiness for change and appropriate skills.

6. Some of the states that have introduced reforms provide good examples. In the Andhra Pradesh distribution utilities, book keeping has significantly improved, now being done within 10-15 days of the month's end. This instills greater confidence in operational decision making as the information is more realistic than the MIS, which differs from the actual numbers, compiled at the end of the financial year. In Rajasthan, the distribution utilities have completed updation of fixed asset registers. They are among the few power sector entities, together with some utilities in Andhra Pradesh, which have financial statements ready for audit completion within four months after the end of the financial year.

7. However, challenges remain in the operational and commercial areas. These include: high T&D losses; operating losses that require huge subsidies and burden the state governments; high employee costs due to adverse employee: consumer ratio; and large borrowings that result in high interest costs. Owing to these challenges in the power sector reform process, the benefits will

accrue slowly. What matters most therefore is strengthening of the management to effectively monitor and control performance.

8. A key requirement of performance monitoring and transparency in operations is to strengthen the financial reporting and accountability framework. This would also help ensure governance and management control of entities, critical for building investor confidence.

9. The study highlights the areas needing improvement in the public financial accountability system. It identifies the gaps and suggests ways to increase the effectiveness of key institutions concerning the entities, such as the audit committee, statutory audit, and internal audit. The rationale for the study has been explained in the concept note (Annexure VIII).

10. The objective of this study is to identify areas for improvement in accounting, auditing, disclosure and reporting practices followed by power sector entities. These include the need to:

- Understand and review accounting and financial reporting processes
- Analyze the gap in current accounting, financial reporting, auditing and internal control arrangements
- Report on areas of improvement
- Improve the reliability of information presented in financial statements

11. Thus, the recommendations aim primarily at informing the Bank's dialogue, feeding into the CAS on the quality of corporate governance and management of public investment.

12. The approach to the study is structured on 27 entities in 7 states (Annexure I), where the Bank is currently involved, in four phases (Annexure II). Central public sector undertakings have not been covered. The study analyzes annual reports, other publicly available material and financial statements. Interviews, surveys and discussions with stakeholders in the states and entities were sampled to understand the practices being followed.

13. Among the key questions examined during the study were:

- Do financial statements give a true presentation of the financial position of the entity?
- Do institutions like the board, audit committee, statutory auditor and regulator mitigate the risk of unreliable financial information efficiently?
- How does the management view the dissemination of reliable financial information?
- What are the constraints in providing reliable information?

14. The scope of the study is confined to the quality of financial information provided by the various power sector entities and does not consider their operational efficiencies. Analysis of the large T&D losses is outside the scope of this study. Annexure VI provides details of the annual reports of the entities studied. For two of the 27 entities, audited financial statements could not be examined in time.

II. INSTITUTIONAL FRAMEWORK

A number of legislative acts have been passed since 1910 concerning regulation of electricity supply, setting tariff mechanisms, accounting principles, and generation, and transmission and distribution companies. These are:

15. **Indian Electricity Act, 1910**[9]**:** This is one of the earliest pieces of legislation on electricity supply. It deals with the grant of licenses and the licensee's powers for electrification of streets and railways, laying overhead lines, levying energy charges to consumers, supply and use of energy by non-licensees, protective clauses and provisions for criminal offences and prosecution. The Act regulates the relation between the licensee that is, the supplier of energy and the consumer.

16. **Electricity Supply Act, 1948**[10]**:** This Act aims at formulating financial norms and a tariff setting mechanism.

17. **Electricity Supply Annual Account Rules (ESAAR), 1985:** This is applicable to SEBs and deals with form, preparation (that is, accounting principles) and submission of financial statements.

18. **Electricity Act, 2003:** It has consolidated the laws relating to generation, transmission and distribution, having repealed[11] the Electricity Act, 1910, the Electricity Supply Act, 1948 and the Electricity Regulatory Act, 1998. The Act aims at unbundling[12] the existing SEBs into separate generation, and transmission and distribution companies. The Act also enables over-riding[13]

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[9] For more information, refer source: *Guide to the Electricity Laws*, Naushir Bharucha, Wadhwa & Co., 2004.

[10]For more information, refer source: *Guide to the Electricity Laws,* Naushir Bharucha, Wadhwa & Co., 2004.

[11]Section 185 – Repeal and Saving - Save as otherwise provided in this Act, The Indian Electricity Act, 1910, The Electricity Supply Act, 1948 and The Electricity Regulatory Commission Act, 1998 are hereby repealed. Notwithstanding such repeal – (2) (d), All rules made under sub-section (1) of Section 69 of the Electricity (Supply) Act, 1948 shall continue to have effect until such rules are rescinded or modified, as the case may be.

[12] Schedule XIII (Section 131- 134) deals with the reorganization of the boards wherein the property of the boards is vested in the state government, who then transfer the property to either a company or a government company in accordance with the terms of the reorganization scheme.

Section 131 (7) explanation:

(a) A "government company" means a government company formed and registered under the Companies Act, 1956.

(b) A "company" means a company to be formed and registered under the Companies Act, 1956 to undertake generation or transmission or distribution in accordance with the scheme under this part.

[13]Section 174 - Act to Have Over-riding Effect - save as otherwise provided in Section 173, the provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act. (Corresponds to Section 52 of the Electricity Regulatory Commissions Act, 1998). Section 175 – Provisions of this Act to be in Addition to and Not in Derogation of Other Laws. The provisions of this Act are in addition to and not in derogation of any other law for the time being in force.

some provisions of other Acts such as the Companies Act, 1956, and is itself overridden[14] by other Acts such as the Consumer Protection Act, 1986.

19. **Companies Act, 1956:** This applies to companies registered under the Companies Act, 1956. It provides the form, content, disclosure requirements and accounting policies to be followed by companies while preparing their financial statements.

[14]Section 173 – Inconsistency in Laws -- Nothing contained in this Act or any rule or regulation made thereunder or any instrument having effect by virtue of this Act, rule or regulation shall have effect in so far as it is inconsistent with any other Provisions of the Consumer Protection Act, 1986 or the Atomic Energy Act, 1962 or the Railways Act, 1989. (Corresponds to Section 49 of the Electricity Regulatory Commissions Act, 1998).

III. RESULTS OF THE STUDY

20. The study was undertaken because of the critical need for reliable financial information, especially as the power sector receives major government subsidies. This need is particularly important with regard to the audited financial statements of power sector entities and the information, which they file with the regulators. As a sizeable proportion of these entities are in the public sector, their standards are considered to be low in corporate governance, financial accountability, transparency arrangements and auditing. This causes concern as the quality of financial information is a major consideration for both private and public stakeholders – compounded by high capital investment and recurring technical and financial losses.

21. A number of stakeholders have addressed the problem of reliability. In the process, they have contributed to a better understanding of the reasons vis-à-vis business and regulatory requirements. Some of these initiatives include:

- A study on the power sector accounting by the ICAI[15]
- Rating exercise by the Ministry of Power (MoP) on the quality of information (as part of a bigger exercise on performance)
- Demand by independent regulators for high-quality information from the licensees
- Unbundling of SEBs into separate corporate entities or profit centers
- Introduction of the new Electricity Act, 2003, which tries to combine the legislation relating to generation and distribution by doing away with the Electricity Act, 1910 and Electricity Supply Act, 1948.

22. These initiatives have placed greater emphasis on the reliability of financial information and the performance of the power sector. However, progress has not kept pace with the dynamics of the business environment; the changes exist more in form than in substance. There appears to be a divergence between what is stated by power entities and ground reality. This is particularly true of financial statements and disclosures to the public and regulators. Given stakeholder sensitivity, sound financial management and disclosure practices are needed for greater accountability with incentive-based performance.

A. How reliable is the financial information provided by the entities?

23. An analysis of the financial statements of power sector entities provides an insight into the current system of reporting and accounting practices followed. There are several areas of concern:

24. **Status of investments in fixed assets:** Investment in fixed assets and capital work-in-progress such as plant, machinery, buildings, (that constitute 56 percent of total investment in the selected entities), is not fully supported by the records. Here again, it is necessary to authenticate operating conditions and values - based on the estimated useful life of these investments. The basic reason for this state of affairs was the absence of a system requiring that the integrated entities maintain a fixed asset register. Hence, the records of these assets, built up over many decades, lie scattered across numerous accounting units, with no centralized system of cost,

[15] Study on Accounting in the Power Sector, Research Committee, Institute of Chartered Accountants of India, 2002 ISBN:81-87072-78-4

location, or specification of individual assets. Rajasthan is one of the few states that have nearly completed updating the fixed asset registers for all power sector entities.

- A review of the financial statements brings out the audit reservations on the existence of assets of the entities. An analysis of the annual reports shows that: over 72 percent of the entities examined did not maintain proper fixed asset records.

- Seventy-two percent of the entities did not carry out physical verification of fixed assets over a two-year period and 56 percent over a three-year period.

25. **Subsidy receivable confirmation and provision:** The subsidy receivable amounts in the balance sheets of the entities represent the subsidies that are recoverable from the respective state governments. The amounts receivable on this account (constituting 14 per cent of total assets) are unconfirmed and, hence, their realizable value is uncertain. One such example is the case of Rs 4,386 crore stated as being owed by the Government of Rajasthan to the state's power sector entities on March 31, 2003, which is not acknowledged in any public document by the government or authorized by the state assembly. During discussions with the energy secretaries of state governments, it was seen that the amount reflected as recoverable from the state government in the power sector entities' books of account was not the amount that the state government planned, proposed or was willing to pay or admit as a liability. In fact, in the state government's accounts, usually no liability is reflected in the statement of liability on account of the power sector entities, in accordance with the cash basis of accounting used. Often, there are memoranda of accounts and the amounts receivable are used as tools for negotiation by the entities with the state government. This is done in order to get periodic state support and to settle loans including those provided by the government. The issue is: Do the financial statements reflect the financial well-being of the entity and its operations, or are they just negotiating tools in the hands of the management?

26. Discussions with the auditors, statutory as well as from the C&AG's office, indicated that a confirmation of this amount is usually not sought by the entity or provided by the state governments. However, for Punjab in 2002-03, the C&AG did qualify the year's income of Rs 3,558 crore on account of government subsidy and also the total outstanding receivable of Rs 5,470 crore reflected in the balance sheet. Of the 12 entities, which had "subsidy recoverable" as a line item in their balance sheets during 2000-03, only four had this amount qualified in the audit report, while the others asserted that this amount was recoverable. Thus, the reliability of overall information, especially without confirmation of such large receivables, needs careful consideration.

27. **Valuation of stores and inventories:** A crucial part of year-end book closing is provisioning and adequacy of inventories. The amounts reflected as inventory of stores (2.4 percent of total assets) are not always supported by periodic physical verification of existence and assessment of operating worthiness, for the absence of which the following reasons are cited:

- Insufficient information
- Absence of procedures like aging analysis and physical verification of stores
- Absence of identification of slow-moving stores

Exhibit 1: Audit Qualifications on Account of Non-Provisioning of Stores

Area – Stores	Over 2 years		All 3 years	
	No. of Entities	%	No. of Entities	%
Inadequate/absence of stores' physical verification	9	36	5	20
Absence/improper system to determine unserviceable stock	11	44	8	32

28. **Pension/post-retirement benefit liability provision in books:** Among the many liability captions in the entities is future pension and post-retirement benefit liabilities due to employees. Most entities either do not provide or fall short in the amount provided which is paid in cash when due. However, in accordance with Accounting Standard 15 issued by the ICAI, this liability is to be determined on the basis of an actuarial valuation (i.e. the process used by an actuary to estimate the present value of benefits to be paid in the future). A review of the financial statements reflects that most of them do not provide for the liability on an actuarial basis. The significance of the liability amount can be gauged from the fact that during unbundling, the liability on account of pension and post-retirement benefits was over r Rs 4,400 crore in Andhra Pradesh as an example[16]. Therefore, a significant gap exists between the actual liability and the figures reported in the financial statements. Further, this warrants attention since there is often lack of clarity about whose liability this relates to – the new entity or the state government. An example is the ongoing dispute in Delhi between the state government and the newly formed entities for staff liability of the erstwhile Delhi Vidyut Board employees.

Exhibit 2: Pension Liability provided as per Annual Report *Amount in Rs (crore)*

States	Staff Liability as per FS	Policy followed by Entities	Comments of Auditor
Punjab	96.84	Charged to revenue	Not qualified
Rajasthan*	26.88	Funded through a Trust/LIC-actuarial	Not qualified
Andhra Pradesh	4,682.18	Estimated basis (in 1 out of 6 entities, others not disclosed)	Not qualified in 1 out of 6 entities
Orissa	2.01	Actuarial valuation	N.A.
Uttar Pradesh	188.84	Actuarial valuation	N.A.
Karnataka	190.11	Actuarial valuation (1 out of 3 entities, others not disclosed)	Not qualified
Total	**5,186.86**		

Source: Annual Reports for financial year 2002-03 of entities.
Note: * In case of JVVNL (Jodhpur), staff liability is a negative figure of Rs 7.09 crore due to mis- classification/non-reconciliation which is not in the accounting principles.

29. **Impact of auditor qualifications on profitability:** In addition to the issues noted in the balance sheets of the entities, there were qualifications in the financial statements of the 25 entities, of which 40 percent had the reported profit either turned to losses or where the reported losses increased by 80-100 percent. Further as shown in Exhibit 3, based on the reported quantified qualifications applied to the combined reported profits for 2002-03, the profits decrease by over 38 percent for the year[17].

[16] Haryana reportedly over Rs. 1100 crores
[17] These adjustments may warrant a detailed investigation – for a more accurate adjustment to the profit and loss account which is beyond the scope of this study.

Exhibit 3: Impact of Audit Qualifications on Overall Reported Profitability (2002-03)

Amount in Rs (crore) Under / Over

Particulars	Punjab	Rajasthan	Orissa	Andhra Pradesh	Karnataka	Uttar Pradesh	Total
(A) Reported profit/ loss for the financial year 2002-03	**(372.44)**	**(32.07)**	**156.85**	**316.00**	**2480.77**	**201.64**	**2750.75**
Impact of qualifications on income							
Sales revenue	-	6.83	(73.08)	-	-	(0.02)	(66.27)
Subsidy	-	(832.29)	-	-	-	-	(832.29)
Other income	0.32	2.07	(0.02)	-	-	-	2.37
(B) Net impact on income	0.32	(823.39)	(73.10)	-	-	(0.02)	(896.19)
Impact of qualifications on expenses							
Depreciation	-	-	0.17	58.05	-	-	58.22
Other expenses	(17.80)	9.76	(11.81)	63.41	43.16	21.65	108.37
(C) Net impact of expenses	(17.80)	9.76	(11.64)	121.46	43.16	21.65	166.58
Adjusted profit/(loss) (A+B-C) for the financial year 2002-03	**(354.32)**	**(865.22)**	**95.39**	**194.54**	**2437.62**	**179.97**	**1687.98**

Source: Annual Reports of entities for financial year 2002-03.

Note: The above states cover 27 entities of which financial statements for the year 2002-03 are available for only 17 entities.

30. **Key reconciliations:** The basic control activity in the book closing process is reconciliations. This has been missing in the accounting practices of the entities and is evident from the repetitive references in the audit reports. Based on the review of 17 power sector entities during the three financial years from 2000-2003 (and for 24 entities over two years), the auditors have made many references on account of incomplete and unreconciled accounts in two and, in some cases, all the three years. These indicate a weak review and reconciliation system, thereby undermining the credibility of the data generated. The issues are:

Exhibit 4: Audit Qualifications on Account of Unreconciled Accounts

Area	Over 2 years		All 3 years	
	No. of Entities	%	No. of Entities	%
Unreconciled Inter- Unit Accounts	14	56	11	44
Incomplete/unreconciled bank reconciliations	10	40	8	32
Unreconciled loans and advances	11	44		
Unreconciled subsidiary and control accounts	7	28	6	24

- A key area is the case of inter-unit accounts (IUT) that have not been reconciled and qualified by the auditor in 44 percent of the entities (11 out of 24) repeatedly over three years. In this caption, a large number of unreconciled issues are usually parked. Inter-unit reconciliation can be explained by an example. A state sector entity has two areas: Region A and Region B. Region A transfers some stores amounting to Rs 1,000 to

Region B. Region B receives the stores but does record that in its books. As a result, at the time of closing the books, the situation would be as follows:

Books of Region A

Head Office Account Dr.	1000	
To Stores a/c		1000

Books of Region B

No entry recorded by B.

Books of Head Office

Stores a/c Dr.	1000	
To Region A a/c		1000
Region B a/c Dr.	1000	
To Stores a/c		1000

Note: Region A's account is reconciled and would be knocked off (i.e. 1000 Dr. would be knocked off against 1000 Cr) during consolidation. However Region B's account would remain unreconciled (i.e. against 1000 Dr there is no corresponding Cr to knock it off). As a result, the consolidated financial statements of the entity on the asset side would show inter-unit (B) account 1000 (an asset in books only) and the auditors would qualify this saying that *the inter-unit accounts have not been reconciled.*

- Bank reconciliation not done or incomplete and qualified by the auditor in all three years for 32 percent for the entities (8 of 25).

- Auditor's report qualified on account of incomplete records for subsidiary and control accounts for a fourth of the entities reviewed during all three years.

31. **Maintaining subsidiary records:** Several entities have failed to update or complete their subsidiary records when closing their financial statements. As a result, control accounts at the head office are closed without reconciling them with the subsidiary accounts at the various circles/units and consolidated journal entries are passed at the head office, thus raising doubts about the authenticity of the numbers. Besides, in some entities, statutory records such as cost records are not maintained or are incomplete. Financial statements based on incomplete subsidiary records raise questions about the reliability of their information. An analysis of audit concerns on completeness or proper maintenance during all three years reviewed showed that:

- Over 28 percent of the entities did not maintain proper cash books.
- Twenty-four percent of the entities did not maintain adequate records relating to stores and spares.
- Over 28 percent of the entities did not have adequate costing records.

32. Additionally, there are other key accounting captions such as fixed assets, sundry receivables and payables, where the auditors have questioned their reliability.

Exhibit 5: Audit Qualifications on Account of Key Account Captions

Area	Over 2 years		All 3 years	
	No. of Entities	%	No. of Entities	%
Absence of confirmation from sundry debtors	9	36	7	28
Absence of confirmation from sundry creditors	12	48	9	36
Fixed assets physical verification not carried out	18	72	14	56

33. **Reliability expressed by the regulator on financial information submitted by licensees:** The independent regulators have demonstrated tremendous patience with the quality and timeliness of reporting by the licensees. For the annual revenue requirement (ARR), due in the end of December, the licensees are required to submit the audited numbers of the prior year (ending March 31) with actuals and projections for six months. In this regard, the regulators have expressed serious concerns about the reliability of information provided (Exhibit 6). The question therefore remains whether further patience is warranted, given the direct impact on the accuracy of tariff setting and subsidy allocations. Besides, the impact of the inefficiency of the utility passed on to consumers and subsidies reaching the intended recipients are not quantifiable. This has a bearing on the regulators' concerns with: the quality of the books of accounts and reports filed for setting tariffs; and (ii) assessing public interest issues such as the true cost of operations and the level of service provided to customers. For this, the regulators need to have the requisite skill sets to study and direct licensees to improve their reporting. Exhibit 6 tabulates the findings of a survey on the reliability placed by the regulators on financial information presented by the utilities.

Exhibit 6: Survey on Reliability of Information submitted to Regulators by Licensees

Reliability Index	1 Bad %	2 Poor %	3 OK %	4 Reasonable %	5 Excellent %	Total %
Accuracy		50	33	17		100
Reliability		83	17			100
Timeliness		33	50	17		100 %

Source: Responses collated from the questionnaires.

34. A further example of this concern is Punjab. The regulator has recommended various steps to the Punjab State Electricity Board (PSEB) to improve the reliability of information, by an order dated May 23, 2003, pointing out that the PSEB has not complied or has partially complied with the directives issued under the earlier tariff order dated September 6, 2002. Some areas of non-compliance or partial compliance re-raised by the regulator are:

- *Improvement in MIS* to provide consistent data with accurate details, explanation of the basis for projections and data sources.
- *Energy audit report* to be submitted at the end of each quarter with the action taken report after fixing accountability.
- *Fixed assets and depreciation* register to contain complete details of assets for enabling the board to estimate the depreciation on assets.

35. **Matching assets/liabilities of unbundled entities:** With the recent unbundling of the sector, there are still many dealings within the sector's unbundled entities (stores, staff, spare equipment, etc). It is important that the books be segregated in substance and not, as in the Rajasthan entities, where assets/liabilities and corresponding income and expenses have been booked in different utilities. The Rajasthan Rajya Vidyut Prasaran Nigam Ltd. (RRVPNL) obtained a loan of Rs 730 crore in its name and then transferred it to the JVVNL causing the loan to be understated with current liabilities being overstated. Exhibit 7 highlights this.

Exhibit 7: Qualifications for Mis-statement of Asset/Liability and Corresponding Income/Expense

Entity	No Detail of Asset/Liability	No Detail of Income/Expense
RRVPNL	1. FDR of Rs 20 crore pertaining to RRVPNL shown in books of RVUNL (2002-03). 2. Loans of Rs 730 crore obtained by the company in its own name but transferred to other companies of erstwhile RSEB; resulting in loans being understated and current liabilities overstated (2002-03).	1. Interest income pertaining to RRVPNL shown in books of RVUNL (amount not quantified).
JVVNL	1. No loan details available with the company (2002-03). 2. Details of loan against FDR not available (2002-03).	1. Interest expense of Rs 41.8 crore booked without loan detail. 2. Interest expense of Rs 0.22 crore booked without loan details.
AVVNL	Details of loan against FDR not available (2001-02).	Interest expense of Rs 0.22 crore booked without loan details.

36. **Other issues:** These relate mainly to audit qualifications. In some cases, the auditors' qualified report, either on the income statement or the balance sheet, does not clarify its actual intent. Thus, such audit qualifications have limited impact. Also, if no segregation or prioritization of qualifications is presented, the importance and relevance of issues raised is usually lost. Moreover, some auditors indicate that the accounting policies were not reviewed, thereby creating serious doubts about the quality of the audit.

B. Are the institutions of financial accountability working effectively?

37. It is now amply clear that concerns about the reliability of financial information provided by state power sector entities are justified and the government needs to tackle this seriously. Stakeholders need to build pressure to make the organizations accountable for their performance. Institutions such as the management, board and audit committees and, to some extent, the regulator play important roles in financial reporting, disclosure, internal control and governance. The functioning of these institutions and their impact on the information generated for various stakeholders have been studied here:

Board and Audit Committee:

38. Recent developments in the power sector in particular and the corporate world in general (Enron, Worldcom, etc) have forced entities and regulatory bodies worldwide to revamp their accounting and financial reporting systems. In India, the Securities Exchange Board of India (SEBI), with mandatory provisions on corporate accountability (Clause 49), has placed a higher responsibility on the management, board and the audit committee regarding financial reporting. Recent trends show an improvement in financial reporting and disclosure practices followed by the power sector entities, and this is reflected in their annual reports (Exhibit 10). However, systemic and procedural issues remain at the organizational and the sectoral level that need to be tackled. This will enable the power sector entities to be at par with the financial reporting and disclosure practices followed elsewhere in the corporate world.

39. **Concept of audit committee:** This relatively new concept in the Indian corporate scenario was introduced in the Companies Act, 1956 by an amendment in 2001. Apart from being a statutory requirement, the audit committee is an effective tool for corporate governance. It is an autonomous committee separate from the management of the entity. After the unbundling of the SEBs into companies, nearly 80 percent of the entities have formed audit committees.

The role of the committee is to carry out a supervisory function and provide independent opinion to the board on matters relating to financial and risk management. Audit committees of the board have been set up in almost all cases to meet the requirements of enabling legislation, but they are largely ineffective. While the current audit committee members are operational directors of the entities, they are not active in the audit committees. Independent members who are professionally qualified are not associated with this important supervisory function. The board is therefore not confident that the management's financial information provided to the government, and the wider public, represents the underlying facts and this fear is confirmed by the external auditors. Nor is there any assurance that management controls operate effectively or that operational matters are attended to with due diligence. The audit committee should place special attention to the system of metering, billing and collection of receivables.

Management:

40. **Book closing procedure followed by the management:** The management has stipulated accounting policies and standards for the entities. In some states, professionals are hired for accounting positions. However, there are delays in presenting financial statements to the public (averaging 22 months after the year-end compared to the standard six months). An analysis of the time taken by various entities to release their financial statements shows an average time lag of 10-12 months. This makes it difficult to understand the financial position of the organization in a timely manner.

Exhibit 8: Closure of Accounts

Delay in Closure of Accounts			
Time taken by entities to close the books (months)	**2000-01**	**2001-02**	**2002-03**
Less than 6	0	0	5
6-8	1	1	3
9-12	1	4	5
13-15	4	1	3
16-18	2	7	0
19-21	2	3	
More than 22	15	9	2
Total	**25**	**25**	**18**
Number of entities, which had not closed their books	2	2	5
Annual reports not available	1	1	4
Total	**27**	**27**	**27**

41. According to Sections 166 [18]and 210[19] of the Companies Act, 1956, the books of accounts should be closed within six months of the close of the financial year. A reading of Rule 4[20] of ESAAR, 1985, which deals with the compilation and submission of annual accounts, also requires this. Thus, the management has a clear task of closing the books of accounts within a specified time frame.

42. **Disclosures:** These are vital to the user of financial statements. Proper disclosure is essential as it not only makes financial statements comprehensible but also highlights the significance of the captioned items. However, the current disclosure practices being followed by various power

[18] In accordance with Section 166(1), every company shall hold, each year in addition to any other meetings, an annual general meeting and shall specify the meeting as such in the notices calling it; and not more than 15 months shall elapse between the date of one annual general meeting of a company and that of the next. This period may be increased by three months (provided it is not the first annual general meeting), for any special reason, by the Registrar.

[19] In accordance with Section 210(3), the balance sheet and the profit and loss account shall relate in the case of any subsequent annual general meeting of the company, to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months or in case where an extension of time has been granted for holding the meeting under the second proviso to sub-section (1) of Section 166, by more than six months and the extension so granted (provided it is not the first annual general meeting).

[20] Every board shall at the end of each financial year, compile its annual accounts for that year and, within six months from the end of such financial year, submit the said annual accounts and the auditor's report thereon to the Central Electricity Authority and to the concerned state government.

entities are inadequate and diverse. The reason for this is ambiguity in the application of the statute. Although the boards have been unbundled into separate entities (which are registered under the Companies Act, 1956), they continue using the provisions of ESAAR, 1985, especially in those areas which are inconsistent with the Companies Act, 1956. Some of the disclosures required to be made under the Companies Act, 1956 are:

- Significant accounting policies adopted in the preparation of financial statements (whereas in ESAAR, 1985 only deviations from policies specified need to be disclosed).
- Disclosures to be made under Schedule VI.
- Other disclosures to be made, for instance under Section 292A relating to the audit committee and Section 217 relating to the Director's Report.

43. The ESAAR, 1985 does not require any of the above disclosures as the disclosure requirements are designed primarily to meet the information needs of the government and regulatory authorities. As a result, entities that are better prepared make disclosures under the Companies Act, 1956. In contrast, those companies that are not in a position to generate the requisite information take shelter under ESAAR, 1985. Such an environment creates confusion as it results from disparate and inadequate disclosures, caused in turn by the practice of disclosure of only certain items under ESAAR, 1985 and others under the Companies Act, 1956. For example, trade receivables under and over 180 days have to be disclosed under the Companies Act, 1956 whereas there is no such requirement under ESAAR, 1985. Companies, which have a mechanism to generate such aging of receivables often provide these disclosures.

44. For transparency and better understanding of the operations and financial position, companies increasingly make voluntary disclosures in their annual accounts. These are often placed under the management discussion and analysis section to address issues such as:

- Roles and functioning of the internal audit department
- Major business plans to be carried out during the financial year
- Steps taken to bring about effective corporate governance
- Corporate social responsibility score card

45. A standard practice among Private Indian and international power sector companies is to disclose the following parameters, which only a handful of the state government entities comply with:

- Composition of audit committee – 54 percent disclosure
- Responsibility of audit committee – only one entity among the 27 disclosed this
- Powers of the audit committee – none of the entities disclosed this

46. **Assortment of accounting policies:** Unless common accounting standards for the sector are accepted and enforced, financial information will continue to be of poor quality. In line with the unbundling process, various SEBs have split into generation, transmission and distribution companies registered under the Companies Act, 1956. However, financial statements are prepared according to standards that may not meet legal requirements and/or recommendations of the appropriate professional body in India. Thus, some conform to the requirements of the updated Companies Act, 1956; some to the ESAAR, 1985 while the vast majority (72 percent of the entities sampled) select accounting polices from both sources of legislation resulting in an assortment that inhibits comparison of financial performance between entities and over time. Given that archaic financial reporting systems are adopted by the SEBs, adherence to applicable

standards has not been possible. A timeframe has also not been established to adopt the standards of the accounting profession in India. There is an urgent need to improve the quality of the books and records of the entities particularly for operating assets, bank reconciliation and payroll costs, including pension obligations.

47. One of the major issues relating to accounting policies is depreciation. The Electricity Act, 2003 requires compliance in financial reporting by power sector companies. This Act has an overriding effect in cases of inconsistency with the Companies Act, 1956 but does not provide guidance on computation of depreciation based on the economic life of assets. This has created confusion in power sector accounting and reporting. Thus, power sector companies (primarily state owned) engaged in the same business and using similar assets, apply different rates of depreciation, thereby creating variations in profit statements. The C&AG therefore asked the MoP to provide necessary clarification and ensure consistency in the financial statements of power sector companies. One Central Public Sector Undertaking (CPSU), in its accounts for 2004, applied the rates of depreciation for tariff purposes as laid down by the electricity regulator; another CPSU applied the rates of depreciation prescribed under Schedule XIV of the Companies Act, 1956, which are substantially higher than the first case. For the former, the profit impact (overstatement) was over US$100 million for the FY 2004.[21] Exhibit 9 further analyzes how different stakeholders treat this policy.

Exhibit 9: Different Approaches to Depreciation

Management		**Auditor**		**C&AG**		**Regulator**	
Policy Followed	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*
(i) Charged in accordance with rates prescribed under ESAAR, 1985.	67%	(i) Qualified	35 %	No comment. Caption qualified on account of under/over statement.	100 %	Recommended caption to be accounted for on IGAAP basis.	17 %
(ii) Charged in accordance with rates prescribed under the Companies Act, 1956.	16 %	No comment. However, caption is qualified on account of incomplete records and under/over statement.	65 %			No recommendation on this caption.	83 %
(iii) Charged using a mix of rates prescribed both under the Companies Act, 1956 and ESAAR, 1985.	6 %						
(iv) Not disclosed	11%						

Source: *Annual Reports* and response of regulators to questionnaires.
Note: The regulator has suggested that accounting standards issued by ICAI be complied with.

[21] *India:Report on Observance of Standards and Codes (ROSC) – Accounting and Auditing,* The World Bank, *December 2004.*

48. Exhibit 10 highlights some significant captions for which different approaches are used by various mandatory bodies for an accounting caption.

Exhibit 10: Different Approaches to the Same Accounting Caption

Fixed Assets

Management		**Auditor**		**C&AG**		**Regulator**	
Policy Followed	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*
(i) Assets recorded at historical cost, less depreciation.	61	(i) Qualified	6	No comment. Caption qualified on account of under/over statement.	100	Recommended caption to be accounted for on IGAAP basis.	33
(ii) Replaced fixed asset not withdrawn from books.	12	(ii) Qualified	6			No recommend-ation on this caption.	67
(iii) Not disclosed	17	(iii) No comment However, caption qualified on account of non-maintenance of fixed assets register, under/ over statement and no physical verification.	88				

Capital Work-in-Progress

Management		**Auditor**		**C&AG**		**Regulator**	
Policy Followed	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*
(i) Indirect expense capitalized in ratio of indirect cost charged to revenue and capital.	33	(i) Qualified	23	No comment. Caption qualified on account of under/over statement.	100	Recommended caption to be accounted for on IGAAP basis.	33
(ii) Indirect expense charged on best judgment basis.	11	(ii) Qualified	6			No recommendation on this caption.	67
(iii) Indirect expense charged on standard rates.	23	No comment. However caption qualified on account of incomplete records and under/over statement.	71				
(iv) Material issued at standard rate.	22						
(v) Not disclosed	11						

Stores and Spares

Management		Auditor		C&AG		Regulator	
Policy Followed	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*
(i) At cost	6	(i) Qualified	12	No comment. Caption qualified on account of under/over statement.	100	Recommended caption to be accounted for on IGAAP basis.	17
(ii) Standard rates	34	(ii) Qualified	6				
(iii)Weighted average rate	39	No comment	82				
(iv) Not disclosed	22	However, caption qualified on account of incomplete records & under/over statement.				No recommendation on this caption.	83

Retirement Benefits

Management		Auditor		C&AG		Regulator	
Policy Followed	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*
(i) Liability funded through a trust or LIC.	28	(i) Qualified	12	No comment. Caption qualified on account of under/over statement.	100	Recommended caption to be accounted for on IGAAP basis.	17
(ii)Actuarial valuation	11	(ii) Qualified	29				
(iii) Actual liability	11	No comment. However, caption qualified on account of incomplete records and under/over statement.	59			No recommendation on this caption.	83
(iv) Estimate basis	11						
(v) Not disclosed	39						

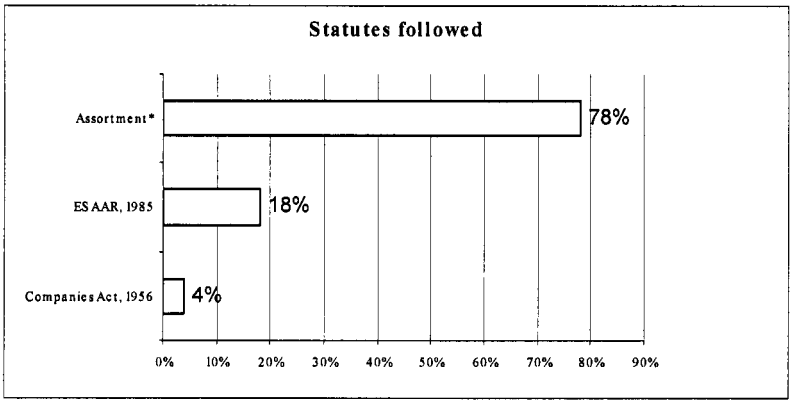
Subsidy

Management		Auditor		C&AG		Regulator	
Policy Followed	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*	*Comments on Caption*	*% Entities*
(i) Amount received as grant credited to appropriate account.	11	(i) Qualified	41	No comment	100	Recommen-ded caption to be accounted for on IGAAP basis.	17
(ii) Subsidy accounted on accrual basis to earn a surplus of 3 percent on capital base.	17	(ii) Qualified	12				
(iii) Subsidy credited to capital reserve and subsequently adjusted as income.	5	No comment. However, caption qualified on account of incomplete records & under/over statement.	47			No recommend-ation on this caption.	83
(iv) Not disclosed	67						

49. Sections 616 and 211 of the Companies Act, 1956 relate to sector-specific laws (Electricity Act, 2003 in this case), and allow the SEBs to interpret and continue with practices and policies. Hence these companies report under different accounting policies because of lack of clarity in the laws. Exhibits 9 and 10 show that on account of these differences, varying standards of accounting and auditing are used in the reporting of financial statements.

50. A review of audit reports, balance sheets, profit and loss accounts and accounting policies followed by the power sector entities, showed the lack of uniform accounting policies required by both the Companies Act, 1956 and ESAAR, 1985. There is, instead, a mix of the two, causing inconsistency, which has rendered inter-company and sectoral comparison difficult.

Exhibit 11: Accounting Policies followed by Entities



*Assortment - a system wherein policies are picked up for different or same caption items from both the Companies Act, 1956 and ESAAR, 1985.

51. The ICAI had produced a white paper titled: 'Study on Accounting in Power Sector' in 2002. The study related to: (i) the existing legal framework of power sector entities; (ii) applicability of IGAAP; (iii) the current form of financial statements and accounting policies and their comparison with IGAAP; (iv) recommendations to bring the accounting practices in line with IGAAP; and (v) roadblocks in implementing the recommendations. However, this has had little impact, given the challenges.

52. **Management information system**: An integrated IT approach with end-to-end solutions should be the objective to cover both technical and commercial data.[22] The present system generates both datasets separately, creating large discrepancies with room for fudging numbers. Transmission and distribution losses could thus provide totally different figures from the two separate sources.

Distribution companies in Andhra Pradesh have made considerable progress in financial MIS in which a significant part is now generated through the accounting system after the implementation of a monthly book consolidation process. This should be shared widely across the country. In most entities, the reporting process is poor, especially in the MIS, which is not integrated with the

[22] A report on this subject (IT solutions) prepared by a committee headed by the CEO of Infosys Technologies is available with the MoP. The present study does not recommend any particular system. Instead, the Central Electricity Regulatory Commission (CERC) may wish to explore this area to create a uniform approach to MIS and reporting.

accounts, and finance function and uses separate channels. Moreover, as the MIS is required for quick decision-making in a dynamic environment, it cannot be generated from the financial reporting system, which is characterized by significant time lags in reporting.

53. **Repetitive qualifications and management attitude:** It is evident from the number of qualifications repeated every year that the management is not interested in solutions because of:

- A large number of trivial issues identified for qualification as a result of which the management does not focus on them.
- Auditors often use the reduction in the number of qualifications as a bargaining tool for additional work.
- A perception that, as the C&AG appoints the auditors, qualifications/ "paras" are included in their reports that would otherwise form part of the C&AG's post-audit report.
- A number of qualifications lacked management focus and materiality and hence received no attention.
- Over-auditing of entities (four different types of auditors – statutory, internal, supplementary and cost) has resulted in a number of observations ("paras") being given out by different auditors. Given the number of observations ("paras") and their perceived relevance, the managements club issues together, seen largely as non-value-adds, resulting in dilution of focus.

54. **Book keeping (Chart of Accounts):** The maintenance of books of accounts in most state power entities is not structured to meet the demands of a dynamic commercial organization. Hence, accurate and timely information in the required manner is not provided. In a study on book keeping in six distribution entities, the following reasons are cited:

- Four out of the six entities followed the ESAAR, 1985 chart of accounts meant only for integrated utilities.
- Only one entity had structured its chart of accounts to meet the cost accounting rules, this being made possible by a skilled team handling the corporate accounts.

55. One view suggests that the problem gets aggravated because the number of professionals engaged in the closure of books and preparation of financial statements is small compared with the number employed in the accounts and finance function. This affects the quality and timing of financial reporting and compliance with regulations.

56. None of the six distribution companies have an online integrated accounting function. Only one entity uses a small accounting package "Tally" to consolidate accounts, while others use Microsoft Office-based "Excel". Also, given the advancements in technology and computers, the manpower in power sector entities is ill-equipped to handle any integrated computer-based accounting and reporting system. Hence, the lack of technologically skilled accounting personnel is a limitation.

57. Besides, none of the entities have a training program designed for refresher and advanced courses to enhance finance skill sets concerning new accounting standards and computers. There is thus a lack of both qualified personnel and skill sets required for a healthy financial reporting system. Discussions with the entities also revealed that they do not have monthly and annual book closing checklists or sign-off procedures.

Internal Audit

58. **Internal audit function:** In most cases the management has set up an internal audit function but it appears to be ineffective: (i) continuing high T&D losses across states; (ii) low materiality of transactions; (iii) an approach that focuses on transactions rather than processes; and (iv) large accounting irregularities, reported by the external auditors, that seem to have been missed (or kept out) by the internal auditors. It may thus be necessary to strengthen the internal audit function in line with best practice in the Indian public sector and a reporting relationship directly with the audit committee of the board. At present a large percentage of the entities' internal audit processes are not commensurate with the size and nature of the entity. This is evident from most statutory audit reports that refer to the Manufacturing and Other Companies (Auditors' Report) Order and point out that the internal audit function is not commensurate with the size of the company. Other aspects such as incomplete records/books, incomplete/absence of reconciliation procedures especially relating to IUT and bank accounts also show the ineffectiveness of the function. The effectiveness of the function is further diminished due to the conflict of interest in the current reporting structure where the function reports to the director (finance) instead of the audit committee. The issues that have surfaced in the study are listed below in paras 59-64.

59. **Internal audit and the size of the entity:** Statutory auditors for several entities have pointed out that the internal audit function is ineffective and not commensurate with the size of the entity.

Exhibit 12: Qualifications for Internal Audit System

Qualification - Inadequate Internal Audit System		
Period	**Over 2 years**	**Over 3 years**
Number of entities	15	13
Total number of entities	25	25
Percentage	60	52

60. **Scope of internal audit:** In most cases, the scope of internal audit has been limited to financial transactions and book keeping. With the lack of skill sets and a sponsor in top management, the scope and approach does not extend to processes and operations of the entity. Consequently, the key aspect of energy audit for reconciliation of numbers regarding power input and billing remains outside the scope of the function.

61. **Skill sets:** The internal audit function in a number of entities is manned by ineffective and uncooperative staff. This reflects the management's lack of commitment and expectation vis-à-vis the function and raises the question of the relevance of skill sets in the function.

62. **Reporting structure:** Presently, in all entities, the internal audit function reports to the director (finance) instead of the audit committee, thereby undermining its own functioning and effectiveness. This reporting pattern can also influence the internal audit report presented to the board.

63. **Reconciliation procedures:** A review of the financial statements reveals that most entities were unable to complete reconciliation procedures before the closure of books. This is evident from the repeated qualifications in the audit reports. The areas where reconciliation procedures were incomplete or absent are:

- Inter-unit accounts.
- Bank reconciliation.
- Reconciliation of the physical count of stores with book records.
- Reconciliation of subsidiary records with control ledgers.

64. While the survey shows that most entities do have reconciliation procedures in place, a review of the annual report indicates that none of these procedures are followed effectively. This in turn raises the issue of the application of internal auditing standards.

External Audit

65. **Choosing the auditor:** For power sector entities within the purview of the Companies Act, 1956, the auditor has to be selected from a panel set up by the C&AG. Since these entities (especially for transmission and distribution) have operated like government departments, and audited by the C&AG until corporatization, their experience is limited to smaller firms. However, the choice of auditor should include consideration of knowledge and capacity to undertake the audit. Besides, the audit fees which power entities pay would seem low if compared with audit fees paid by other entities of similar size if related to revenue. In some cases empanelled auditors have refused to audit distribution entities, given their spread and size, as the audit fees do not even cover traveling expenses to audit locations. This arrangement of audit would clearly generate sub-optimal audit quality. Budgets for audit fee need to be reviewed and enhanced where appropriate.

66. **Number of qualifications:** In line with the scope of work envisaged the auditor's opinion in the financial statement provides an independent and objective assessment of the financial statement presentation of an entity. The qualifications in the opinion are meant to provide information on the factors that impact the business and financial position. Not one of the 23[23] entities examined was able to secure a clean audit opinion from its external auditors. The financial statements of power sector entities carry a plethora of qualifications that require complex study, yet the auditor pronounces the financial statements as "true and fair". In most cases, audit opinions are heavily qualified -- both by the entity's private auditor and the C&AG. In the case of Uttar Pradesh and Rajasthan over 100 qualifications were made by the auditors. While there has been some improvement in the number of qualifications over the years, this aspect appears to be a recurring feature. Given the number of qualifications and related aspects, it is surprising that there was not a single "adverse" opinion or "disclaimer of opinion" in these financial statements.

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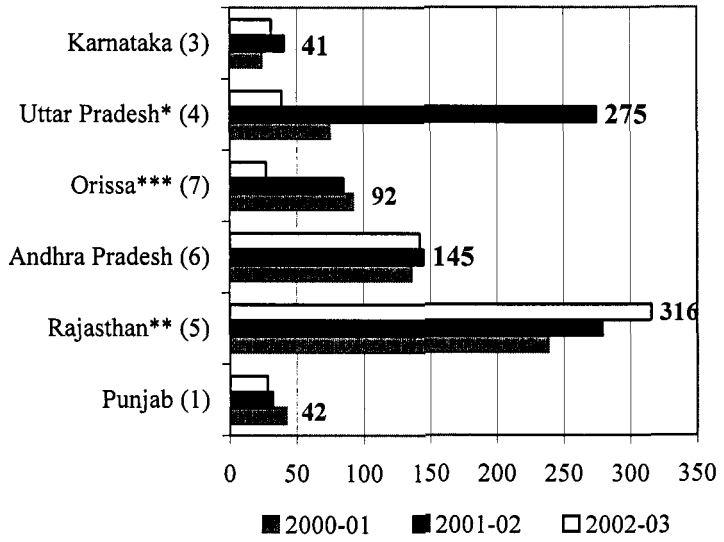
[23] Of the 27 entities reviewed, two had not submitted their annual audited financial statements for FY 2003-04 and in two other cases the entities were electricity boards rather than entities incorporated under the Companies Act, 1956.

Exhibit 13: Number of Qualifications in the Auditors Reports over a Three-Year Period



Note: * For Uttar Pradesh the books of KES have not been closed for 2000-03. For UPJVNL the *Annual Report* for 2002-03 and for UPPCL the *Annual Reports* for 2000-01 and 2002-03 are not available.

** *Annual Report* for RRVUNL for 2001-02 is not available.

*** *Annual Reports* for NEESCOL for 2001-02 and in the case of GRIDCOL for 2002-03 are not available. The books for NEESCOL, CESCOL, WEESCOL and SEESCOL have not been closed for 2002-03.

67. This provides a rough idea of the number of qualifications and the numerous accounting captions recorded by the auditors[24]. Keeping track of their impact and understanding the overall financial position of an entity is thus quite a challenge.

68. **Unquantifiable qualifications and reporting of impact of qualifications on the financial statements:** In most audit qualifications the auditor pronounced the impact on financial statements as "non-quantifiable" without giving any amount against them. Usually, these non-quantifiable qualifications are on account of events, which impact the business but, given the situation, are not quantifiable. However, in the power sector entities, these non-quantified qualifications get repeated annually. For 2002-03, of the 17 entities analyzed, non-quantified qualifications related to 56 percent of the total funds invested which amounted to Rs 83,717 crore.

Exhibit 14: Size of Accounting Captions with Auditor's Non-Quantified Qualifications

Amount in Rs (crore)

Area	Amount	%
Total funds invested (total of balance sheets).	83,717	*100*
Non-quantifiable qualifications on account caption:		
Fixed assets & capital work-in-progress	32,700	39
Receivables	14,448	17

[24] The number of qualifications is but one indicator- the level of materiality of the issues raised is another. Additionally delays in finalization of accounts are another factor to take into account before comparing performance among entities. A more detailed investigation was outside the scope of this study.

69. **Quality of qualifications:** Financial reporting must principally provide intelligible statements and not be difficult to comprehend. This is clearly an issue, given the number of audit qualifications that need to be considered, before arriving at the overall financial position. Apart from this, a recurring characteristic was the reporting of immaterial qualifications.

70. While the concept of materiality is subjective, such immaterial qualifications, which do not actually impact the "true and fair" view of the auditor, undermine the significance of really important qualifications and lead to significant issues getting lost. For the record, it can be mentioned that the quantified qualifications of 17 entities for 2002-03 were either under Rs 10,000 or less that 0.5 per cent of the operational revenues (referred to as "Materiality for Analysis" - MfA). The analysis shows that only 42 percent of the qualifications would *remain in the* audit report if material qualifications alone were considered for reporting purposes.

Exhibit 15: Qualifications for 2002-03 falling below Materiality for Analysis

State	**Qualifications**		
	Number below MfA	**%**	**Total (i.e. 100%)**
Punjab	18	69	26
Rajasthan	87	72	121
Andhra Pradesh	4	9	42
Orissa	11	58	19
Uttar Pradesh	5	50	10
Karnataka	4	50	8
Total	**129**	**58%**	**226**

Note:- Annual Reports for 9 utilities are not available. Of these, 5 have not closed their books for the financial year 2002-03.

71. Items such as environmental liabilities cannot always be quantified. In these cases the auditor's judgment on their impact must prevail.

C. What are the principal causes for institutional and systemic weaknesses?

72. Several factors are responsible for institutional weaknesses. Socio-political, institutional and cultural factors require re-interpretation of the incentive structure. Problems related to manpower, process and technology can be overcome by giving them greater attention. Above all, it must be kept in mind that unbundling of the SEBs requires extensive preparation and groundwork. It appears that the role of accounting, auditing and internal control in managerial responsibility is inadequately appreciated by the senior management, which in fact is answerable for both financial and operational performance. This may be partly due to the government's selection and recruiting procedures. It is therefore imperative that the government recognizes the role of accounting, auditing, control, management information and good corporate governance in improving sector performance.

73. **People:** Power entities are presently deficient in the manpower resources required to meet all finance and accounts functions. The shortage of skilled personnel relates to developing effective MIS for decision making, ensuring timely closure of books, reconciling various accounts, completing and updating statutory records (like fixed assets registers) and other subsidiary records (like loans and advances registers). The following findings emerged from the responses to questionnaires used in the study:

- Entities with employees not exceeding 500 only have 4 percent comprising qualified professionals whereas for entities with more than 500 employees, the figure is approximately 5 percent.
- For internal audit, entities with up to 100 employees have only 15 percent comprising professionals whereas for entities with more than 500 employees, the figure is approximately 3 percent.

74. **Employee mind-set and training:** The power entities do not have a system that recognizes merit or an evaluation based on performance and results[25]. Since promotions are time-bound, their personnel lack the incentive to improve, innovate or be creative. Additionally, since the management has often been drawn from the civil service, there are strong ties with the administration that reduce independent decision making. Assessment of training needs has not been built into the human resource management system of the entities. Thus, monitoring of skills and refresher and training programs have not been accorded priority.

75. **Autonomy:** Even though the SEBs has been unbundled, some still lack financial and operational autonomy.

- ***Financial Autonomy*:** The SEBs has unbundled in form but not substance. Most resultant entities are still controlled by the erstwhile directors. In Rajasthan, where the SEB has been unbundled into five entities, all have only one finance director. Similarly in Uttar Pradesh, out of the four entities, three have the same finance officer. On the other hand, distribution companies in Andhra Pradesh have the autonomy to undertake a number of initiatives in finance and accounts and in implementing an online accounting system.

- ***Operational Autonomy*:** The existing unbundled entities also lack operational autonomy. For instance, in one state the directors of an entity are members of the audit committee of another

[25] This is reportedly a systemic problem across governments and state owned entities.

entity. In other cases, entities have a common chairman for their audit committees. An example of this is Rajasthan's two entities: RRVPNL and AVVNL. A similar situation exists in Orissa for the two entities: North Eastern Electricity Supply Company of Orissa Limited (NEESCOL) and Western Electricity Supply Company of Orissa Limited (WESCOL).

76. **Resources for capacity building:** Historically, given that the finance and accounts function has not been at the core of the "engineer driven" business, there is significant resource constraint[26] on new investments and system upgradation. Further, in the reforms phase, emphasis has been laid on improvement in technical rather than financial systems. Accordingly, with limited resources, utilities have not been able to implement various measures mandated by the regulators, often creating a hostile regulatory environment.

77. **Incentives for improving reliability of financial information:** In the present scenario there are no incentives available to the entities for providing reliable information. The MoP needs to introduce an incentive scheme where entities, which provide reliable information, are given some recognition or credit. Such entities should be given higher weightage when funds are released under the APDRP. This will encourage healthy competition among the existing entities to provide accurate and fair financial information.

78. **Computer literacy:** The level of computerization is very low in the entities, as seen from the ratio of personnel to computers and the use of accounting software. This is extremely unsatisfactory in the dynamic operating environment and the management's need for decision making. Responses to the questionnaires substantiate this:

- Only 36 percent of the entities have a ratio of one finance person to one computer and 27 percent have a ratio as high as 5-6 persons to one computer.
- 36 percent of the entities use basic accounting software (such as Tally) and 64 percent use MS office (Excel and Word).

79. **Sanctions framework:** Since the SEBs are state undertakings, a strong operating sanctions framework for stakeholders' benefit does not exist, be it (i) employees for non-performance or negligence;(ii) auditors for inadequacy of audit; and (iii) management for delivery of targets. With this lack of pressure on accountability, stakeholders operate without operational and regulatory requirements.

80. **Internal audit:** The issue presently is a lack of standards for internal audit, auditor's skills and tools for assessing the technical aspects of losses attributed to transmission and distribution. The conflict of interest between the head of the internal audit function, who reports to the finance director, and the external auditors must be resolved.

81. **Audit committee:** Audit committees of the board have been set up in line with legal requirements but are largely ineffective in almost all cases. The directors on the audit committee are operational heads, and hence do not undertake a mutual supervisory function. The independent members of the committee do not possess professional qualifications associated with this important function. The board cannot therefore assume that information provided by the management is accurate. This doubtful scenario applies to the government and the public as well.

[26] The constraint is likely more of quality of resources than of quantity..

IV. LESSONS LEARNT

82. A major lesson learnt by the Bank is the importance of strengthening the institutions of public financial accountability in any reform process that involves large public investment. The need for unqualified audited financial statements within some reasonable time frame was not sufficiently emphasized.[27] This was clearly underemphasized in the policy dialogue preceding the power sector reforms during the 1990s that led to unbundling of SEBs. No comprehensive assessment of the institutions of public financial accountability was made; accurate, fair and timely financial positions of the entities was not generated; nor were proper account balances produced. Thus, concerted effort and time will be needed for these problems to be fully resolved. As observed earlier, these entities are unbundled "de jure" but remain bundled "de facto". Karnataka proves the point, whereby the four distribution companies remain under a common senior management. Most entities still continue to have qualified audited financial statements.

83. In spite of their commercial significance and customer service orientation, the culture of the organizations remains bureaucratic. Unless this culture changes substantially, many issues would remain unaddressed. The system needs overhauling to shift it from a political and civil service environment to one, which is performance oriented and financially sustainable. In this regard, an independent observer has pointed out that the lenders should be more stringent in their statement of conditions for development assistance to the sector. Another observer has suggested that privatization is the only answer, given the long-standing organizational culture prevailing across the system and lack of autonomy vis-à-vis the government. Yet another believes that the time has come to emphasize the role of corporate governance for all public sector entities just as it is for listed companies. This is particularly so for public interest entities,[28] such as in the power sector, funded by large sums of public money.

84. The study validates the hypothesis that the financial information provided by the power entities is unreliable. This conclusion is based on: (i) findings of the desk review of published material; (ii) responses to survey questionnaires and discussions with the officials of the entities; and (iii) other key stakeholders. Among the more glaring facts, which have come up, is the impact of audit qualifications on profitability reflected in the annual reports of the entities. If these qualifications are given effect then, in 40 percent of the entities, the reported profit would either turn to losses or the reported losses would increase by 80-100 percent. One of the crucial indicators for measuring the reliability of financial information is the "true and fair" view of profit and loss and the state of affairs (i.e. balance sheet) of the entity. However, apart from such major variation in the reported amounts after giving effect to audit qualifications, there is the question of operational efficiency and recoverability of 83 percent of the total assets (i.e. fixed assets, subsidy receivable and stores). These being suspect due to incomplete records and weak controls, it would then be fair to say that the financial information provided is unreliable and a serious cause for concern.

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[27] Additionally adequate time and resources required for the prioritized set of reform actions were not provided in the institutional development plans.

[28] In India, public interest entities could include all listed companies (equity/debt), banks, financial institutions, mutual funds, insurance enterprises and companies with turnover in excess of a specified limit per year, companies with borrowings in excess of a certain limit and all holding/subsidiary companies of these. The ICAI Council has enunciated a similar definition for Level-I enterprises in connection with prescribing simplified accounting and reporting requirements for small- and medium-sized enterprises.

85. A number of reasons can be given for this poor state of affairs. Lack of reliable financial information systems, poor accountability and weak controls are the key aspects that impact decision making within the organizations. The existing accountability institutions such as the management, internal audit, external audit, audit committees and the regulators are either ineffective or weak in their present state.

86. Accordingly, adequate emphasis needs to be placed in the reform process on the systems and institutional needs relating to the generation of reliable and timely financial information for better financial accountability in the entities. The emphasis has to be similar for reduction of T&D losses, commercialization, better consumer services and improved MIS. In Orissa for example, after several years of reforms, the entities have still not been able to sort out the gap exceeding Rs 1,000 crore in receivables/payables between the companies. Further, issues regarding financial information led to one of the private players "abandoning" the company, because of which its accounts have not been approved and closed by the board meetings for the past four years.

87. Another key factor is the effort for change management. A wide and deep initiative on institutional capacity building can generate commensurate results, as in the case of Andhra Pradesh. This has to be considered along with the "tone set at the top" by the political establishment. Senior management of the entities and Government (representing the owner) need to give priority to this important aspect of reform.

88. The central and the state governments, representing the shareholders and the public, have a significant role. They may choose not to tolerate the inefficiency and work on efforts required to incorporate basic practices and strengthen systems of financial accountability. It is widely believed that a modest reversal in the existing high level of T&D losses[29], from improvements in financial information and lack of controls, would pay rich rewards and disentangle significant resources of the state governments.

[29] Reportedly over 35% in some cases

V. WAY FORWARD

89. Lack of attention to financial accountability and management control is a symptom of the malaise in the sector. Poor financial reporting and systems enable vested interests within and outside the utility to continue to: (i) inappropriately access public resources; and (ii) tolerate incompetence and neglect of work. Though this is a subset of the larger governance problem in the sector, its solution is unlikely to be independent of the sector's governance problems.

90. During the study the various stakeholders clearly pointed out the "late-start" of improvement in the financial and reporting systems. It was emphasized that reliable and timely financial information is a key component of the overall reform program and a mainstream dialogue one, rather than a supporting one. The template for corporate governance for the public sector has yet to be promulgated. The power sector could be the point for departure. The appointment of independent directors is a case in point.

91. The way forward would require dialogue and action on major issues with stakeholder groups: state and central governments, the sector entities, regulators and institutions. A principal challenge is to change the traditional administrative/bureaucratic mindset[30] of the entities towards more managerial and performance orientation. This raises the question of the skills and background that are critical for the selection of the CEO/CMD. Empowering the finance function by appointing a financial management professional as the CEO/CMD may help since the medium-term challenges faced by these utilities are largely governance and finance oriented. Other solutions may emerge in a focused brainstorming session with stakeholders. One commentator has suggested that competitive selection of Finance Directors including consideration of outside candidates might also be considered.

92. The objective of the recommendations stated below is to enhance the institutional capacity of the sector to strengthen governance and operational organization concerning people, processes and technology.

Further dialogue with power sector entities

93. The entities are the key stakeholders in the process of improvement and are in the best position to implement operational plans. Long-term players are required in management to be held accountable for their actions or inactions. There is also an argument that senior managers from the private sector should be inducted on a selective basis to infuse a sense of financial discipline and accountability in the system.

Some major actions could be:

- ***Clean audit opinion over a period***: The sector entities should seek to eliminate all qualifications and aim for a clean report over a period of time, say three years. This objective would put pressure on the management to work towards the removal of repetitive qualifications and of the non-material ones.

[30] In some SEBs, the chief accountant's job was performed by engineers and the chief accountant is even designated as chief engineer-accounts.

- ***Reconcile accounts with the state government on an annual basis*:** The numbers related to subsidies is usually significant and, hence, action to confirm this amount would provide significant assurance.

- ***Disclose transactions with related parties:*** This aspect would again address the issue of non-reconciled accounts in the state government power sector as a whole, leading to improved assurance across the entities.

- ***Invest in an integrated accounting system*:** This single item can have the most significant impact on the quality and reliability of financial reporting information. With an integrated accounting system, there are more opportunities to link in with operational systems and thus reduce manual interventions in the accounting process. Entities often do understand the importance for this because of other interests. Besides, being an internal effort, it may end up being de-prioritized.

- ***Create an active and operational audit committee*:** Most of the entities studied have audit committees whose members are usually operational directors, thereby removing any element of independence and supervision. Given its supervisory functions, which are now even more important in the changed business environment, the audit committee needs to be made more effective by: (a) appointing independent directors; (b) providing a clear charter for the audit committee; (c) ensuring that the internal audit function report to the audit committee instead of the director finance or chairman (as is usually the case); and (d) placing the reports of the audit committee in the public domain.

- ***Incorporate the operational tools of improved financial reporting*:** The entities should aim at developing appropriate tools in the form of checklists for consolidation and book closure, reconciliation procedures, responsibility matrix and other related issues to ensure accuracy, completeness and timeliness of financial reporting. Additionally, another aspect that is lost with movement of personnel is the reporting processes followed by the units for monthly and annual book closure. This can be streamlined, strengthened and documented for which an important starting point is the revamp of the chart of accounts.

- ***Disclose monetary impact of T&D losses*:** In order to be more transparent on this account, rather than disclose the units lost, the entities should disclose the monetary loss that the shareholders incur on this account (or a loss range, if required).

- ***Adherence to the statute on book closure*:** Clean audit opinion and an integrated accounting system are essential. With this, the entities also need target timely closure of books and adherence to Sections 166 and 210 of the Companies Act, 1956 that calls for the adoption of accounts within six months of closure of the books of accounts.

Further dialogue with the state governments

94. The state government being the owner of equity, and usually also the manager of these entities, has to play a significant role, especially in policy making for the sector's efficiency.

- ***Development of a customer service charter*:** This would address unclear operational areas, which can be used by the entities to ascribe actions to the government and, conversely, applied by the government to pull up the management for its actions and

decisions. For this, a customer service charter[31] should be put in place, with the following in mind:

- Being primarily an agreement between the state government and the entity, the charter should set out expectations, roles, commitments and responsibilities, with the focus on delivery of efficient and high-quality service to the customer.

- The government should lay down service levels expected from the entity wherein: (i) the subsidy commitment, its delivery mechanism and timing is clearly articulated: and (ii) the roles and degree of financial and operational autonomy are defined upfront, thereby addressing any issues of state governments not providing autonomy.

- Getting the customer involved in service standards brings about transparency and adherence to delivery requirements. It also provides the public a mechanism to pressurize the parties to the agreement and become accountable for their actions or inaction.

- The charter can include the T&D loss statement, which explains how much was lost (in units and cost), and the process by which this is to be mitigated, through either (i) additional tariff burden on the customer or (ii) government subsidy impacting the taxpayer.

- ***Hiring of relevant skill sets***: This will allow power sector entities to recruit suitable qualified professionals from the financial management community. Among the key issues cited by sector entities is their inability to recruit the relevant skill sets on account of state government embargos on recruitment and their inability to offer market compensation. Thus the state governments may consider the Andhra Pradesh model, wherein appropriately skilled professionals were hired as consultants for 1-3 years, thereby imparting the required skills to manage the function more efficiently.

- ***Monitoring of progress***: The state governments need a system for follow up and monitoring of the program to strengthen the institutional capacity for financial accountability. For this, the governments should place the issue of improving the reliability of financial information on the regular agenda of their boards. Such monitoring would show the entities that the state governments are serious about getting fully involved in improving governance and accountability.

Further dialogue with the central government

95. The central ministries, being the primary policy making bodies and sources of funding, play a key role in nudging forward the steps being taken by the state governments and sector entities. No doubt, lending to the sector without enhanced conditionality on the quality of financial information would be imprudent. Lenders need to be more vigilant. For example, they should not accept qualified audit opinions, as in the case of listed companies (Clause 49 of SEBI). Similarly, the appointment of independent directors on the boards of all power sector entities would strengthen the quality of governance and accountability. Another issue of corporate governance that requires attention is the manner in which auditors are appointed – external and

[31]This is an expansion of the concept of the purchaser provider reported in the *Karnataka State: Public Financial Management and Accountability Study*, February 2004.

internal. One observer pointed out that the appointment of external auditors should rest with the board and have the C&AG's concurrence.

Some of the principal action areas that can be pursued by the Bank are:

- ***Application of appropriate common set of principles of governance and accountability*:** The power entities have a significant involvement with the public regarding: (i) usage of public funds (investor/shareholder); (ii) impact of services on the public at large (customer); and (iii) use of publicly raised funds (public banks/ development funds). Basically, the profile would be similar to the publicly listed companies. However, it is evident that the corporate governance principles applicable to publicly listed entities do not carry weight in the public entities, which have the least supervisory obligations. In view of this, some of the main obligations applicable to publicly listed companies (such as the recently notified revised Clause 49 of SEBI) should also be made applicable to these public sector companies and include:

  - Assertions by the CEO and CFO on the operation and adequacy of internal controls over internal financial reporting.
  - Appointment of independent/non-executive members of the audit committee and the board.
  - Minimal charter of the audit committee.

- ***Design new incentive mechanisms such as Accelerated Power Development Reforms Program (APDRP)*:** While it is still being debated as to how far such schemes are effective and can be monitored, there may be some scope of incorporating important parameters into the CRISIL ratings, done by the MoP. These ratings build in certain incentives for disbursal of funds under the APDRP. Among the rating parameters considered are factors on financial risk analysis, others and the progress in attaining commercial viability (Annexure VII). However, some of the current parameters on "others" are not as measurable as for other areas. Accordingly, the following parameters can be modified to make them more measurable and transparent:

Current Parameters

- Current quality of information systems.
- Consistencies in information received.
- Extent to which the utilities have been able to computerize their systems.

Modified Parameters

- Timeliness of book closure - audit opinion date.
- Number and significance of audit qualifications.
- Independence of audit committee – appointment of independent audit committee members.
- Size and existence of unreconciled IUT.
- SERC directives on quality of information, if any.
- Extent of usage of computer applications for: (i) energy flow monitoring;
  (ii) customer billing systems;
  (iii) complaints management;
  (iv) accounting system; and
  (v) other uses.

Another aspect, which can be addressed, is the weightage of "others", which currently is marginally over four per cent in the overall rating. This can be suitably increased to reflect the importance and focus on reliability of information. The central government could also explore other avenues like allocation of additional power to incentivise the state government power sector entities.

- ***Clarification on statute relating to accounting policies – Electricity Act, 2003***: The central ministry could issue a clarification in unambiguous terms about the statute to be followed and its related policies. This can be done by way of an order or by introducing new rules in the Electricity Act, 2003. Given the implementation issues, clear timelines need to be provided, within which the transition needs to be achieved.[32]

- ***Chart of accounts***: A common chart of accounts would assist in consistency of financial information provided to the government, management and regulators.

Further dialogue with regulators

96. Can anything be done to improve the regulator's effectiveness? The SERCs are amongst the few bodies that can generate adequate responses from the sector entities. They can impose conditions aimed at improving the reliability of information and advances in MIS. The areas where dialogue can be opened include:

- ***Timeliness and quality of audited financial statements***: The regulator can demand that ARR filings carry the prior year's figures from the audited financial statements. Many licensees file unaudited numbers, even though the Companies Act, 1956 mandates that the entities must ready their audited accounts within six months of the end of the financial year. Audit qualification should be read carefully and entities reprimanded for providing unreliable information[33]. Regulators could allow an amount in the tariff for improvement of accounting systems and then monitor for improvement.

- ***Limited review of ARR filing actuals***: The ARR filing meant to provide the numbers based on actual performance for the six months ending September 30th. The regulators may demand that the auditors subject this to a "Limited Review". This is similar to entities listed on the stock exchange, which are required to have their quarterly numbers subjected to a limited review by the auditors within a month of the end of the quarter. This step would lessen the scope for any "adjustments" that the licensees perform and also make the projections for the six months more realistic.

- ***Laying down an improvement roadmap and its monitoring***: This mode for laying down areas of improvement in reliable and timely information (as done by the Punjab regulator[34]) can put pressure on the entity to get its house in order, in addition to laying down a transformation timeline within which to get results.

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[32] As the Electricity Act, 2003 supersedes all existing acts and rules there is a need to review the sections in the Companies Act, 1956 related to accounting policies and depreciation so that there is harmonious construction between the two in these matters.

[33] In cases where penalizing an already bankrupt entity by deducting funds is unlikely to yield good results other measures would need to be explored.

[34] See note on reliability expressed by regulators on financial information submitted by licensees in Section IIIA.

Further dialogue with the accounting and auditing profession

97. The need for a clear cut and common statement of accounting policies[35] and financial reporting is paramount. So long as there are conflicting rules, the quality of financial information will remain problematic. Amongst the institutions that the Bank can work with are C&AG, the ICAI and the ICWAI. The profession could prepare a template for accounting reforms needed in the power sector and a manual of procedures that are required for implementing a more modern system of financial management, control and accountability.

Areas where dialogue can be opened include:

- ***Choosing the auditor***: The choice of auditor can be made more transparent in order to: (i) get the relevant capacity, and (ii) provide a minimum level of fees based on the size of entities. This can be similar to banks, where the auditor for the head office must have a minimum number of partners (15). Also, fees are based on the total asset size.[36] A similar framework can be developed for the power sector entities to improve the quality of audits.

- ***Classification of audit opinions***: The C&AG's report issued to the sector entities does not sufficiently project the degree/seriousness of qualifications by the auditor. A classification pattern on the lines of clean, qualified, adverse and denial of opinion would be a fundamental input for the financial statements.

- ***Disclosure on standards of auditing and scope of audit***: The C&AG's report included in the entities' annual report does not refer to the standards of auditing that have been followed and is a basic gap in understanding the financial statements, since the scope and approach of the audit is unclear. This is so in supplementary audits, where an audit is performed by the C&AG after a chartered accountant has issued an audit opinion. Disclosure of this would provide a better understanding of financial statements. The C&AG's reports on the power entities should also be disclosed in the C&AG's annual report to the legislature.

- ***Prioritization based on materiality of qualifications***: Usually, when the C&AG is the prime auditor, there are a large number of qualifications. The manner in which the qualifications are presented may often lead to important issues and significant qualifications being missed. However if these same are prioritized and classified, a better understanding of the financial statements will result. In particular, a common understanding on what is a material error for financial reporting needs to be articulated.

- ***Performance evaluation of auditors***: The ICAI has started initiatives on peer review mechanisms. However, there is a need to significantly enhance this effort in order to bring about consistency in adherence to standards of auditing and reporting.

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[35] This study does not recommend that accounting standards for each sector be different from those that apply to general purpose financial statements that is, Indian GAAP. However, the regulators may recommend additional reporting requirements. Here too a common set of requirements across the states is advisable.

[36] See footnote 36 of India: Report on Observance of Standards and Codes (ROSC), Accounting and Auditing, The World Bank, December 2004.

- ***Training of C&AG auditors in modern "attest" auditing*:** Given the advancements made in accounting and auditing standards over the last few years, a revised training curriculum for the auditors to upgrade and update the skill-sets should be a priority.

Government's Comments

The Ministry of Power provided comments on the Note to the Ministry of Finance on 19th April 2006. These were forwarded to us on 11th May, 2006 by the Dept. of Economic Affairs. The Government's comments and our response thereon is provided below:

"While the Policy Note has definitely suggested a way forward, the Dept. of Economic Affairs should keep in view that these dialogues with stakeholders will be a long drawn process. It is not clear from the recommendations as to which entity would guide and facilitate the dialogues and consequential actions. A dedicated coordinating systems/structure to conduct & conclude the dialogues and evolve a time bound action program will be required to be identified /set up. The same structure can take up the task of development of performance indicators, operational plan and monitoring the progress of implementation. This structure should involve professionals with required skill set and should be given the control over deciding the incentives based on achievements."

Bank's Response

The Ministry of Power should take the lead for guiding and facilitating the dialogue and consequential actions. In this regard, the Ministry of Finance and the Ministry of Company Affairs along with the Comptroller and Auditor General are among the key stakeholders at the Union government level.

98. In conclusion, given the various actions listed above, there is a requirement to improve the reliability of financial information emanating from the state power sector. It would help if the central government developed a monitoring system for tracking progress. For this purpose, the Bank could, in consultation with the central government, develop a set of performance indicators for improved results and outcomes. It would also help if the accounting and auditing profession took concurrent responsibility to emphasize to the government that infusion of professional accounting skills is fundamentally important to the state power sector.

VI. LIMITATIONS

99. As tasked, the work discussed in the earlier sections is based solely on information from the Bank, power entities and also limited discussions with the key stakeholders of these entities. In this regard, the ultimate responsibility for accuracy and completeness of data shall lie with the respective organizations. There is no opinion or any other form of assurance on the functioning of any power entity.

100. The results of the work, the responses to the questionnaires, and other discussions held with various stakeholders comprise the evidential matter that has been relied upon while performing the task. The report has not been discussed with the entities analyzed at this stage. However, it has been discussed with the Union Government-Ministry of Finance, Ministry of Power and officials of the Comptroller and Auditor General of India. The formal response of the Government of India has been incorporated in the body of the Report.

101. The intention is to disseminate the results of this work with the stakeholders including the management of the entities involved. The views of these entities and state governments would enrich the quality of the debate and understandings to support the way forward being proposed in this Report. In this regard it is important to note that this study is more about the institutions of public financial accountability (that are a common requirement) than the internal management systems of the entities that may vary across the states and the entities themselves. Further work is necessary for a greater appreciation of the internal Management Information Systems (MIS) and procedures of the entities.

ANNEXURE I List of Entities covered by the Study

State Power Entities covered by the Study	
Punjab	
PSEB	Punjab State Electricity Board
Rajasthan	
RRVUNL	Rajasthan Rajya Vidyut Utpadan Nigam Limited
RRVPNL	Rajasthan Rajya Vidyut Prasaran Nigam Limited
JVVNL (Jaipur)	Jaipur Vidyut Vitran Nigam Limited
JVVNL (Jodhpur)	Jodhpur Vidyut Vitran Nigam Limited
AVVNL	Ajmer Vidyut Vitran Nigam Limited
Orissa	
OPGCL	Orissa Power Generation Corporation Limited
OHPCL	Orissa Hydro Power Corporation Limited
GCOL/GRIDCO	Grid Corporation of Orissa Limited
NEESCOL	North Eastern Electricity Supply Company of Orissa Limited
WESCOL	Western Electricity Supply Company of Orissa Limited
SESCOL	Southern Electricity Supply Company of Orissa Limited
CESCOL	Central Electricity Supply Company of Orissa Limited
Andhra Pradesh	
APPGCL	Andhra Pradesh Power Generation Corporation Limited
TCAPL	Transmission Corporation of Andhra Pradesh Limited
EPDCAPL	Eastern Power Distribution Company of Andhra Pradesh Limited
SPDCAPL	Southern Power Distribution Company of Andhra Pradesh Limited
CPDCAPL	Central Power Distribution Company of Andhra Pradesh Limited
NPDCAPL	Northern Power Distribution Company of Andhra Pradesh Limited
Karnataka	
KPCL	Karnataka Power Corporation Limited
KPTCL	Karnataka Power Transmission Corporation Limited
KREDL	Karnataka Renewable Energy Development Limited
Tamil Nadu	
TNEB	Tamil Nadu State Electricity Board
Uttar Pradesh	
UPRVUNL	Uttar Pradesh Rajya Vidyut Utpadan Nigam Limited
UPPCL	Uttar Pradesh Power Corporation Limited
UPJVNL	Uttar Pradesh Jal Vidyut Nigam Limited
KES	Kanpur Electricity Supply (subsidiary)

ANNEXURE II Approach to the Study

Phase I – Assessment of Requirements

The aim was to: (a) perform a high-level assessment of the existing financial reporting and auditing related processes; and (b) understand implications of revisions that might be undertaken by the power entities based on recommendations. The activities, which were carried out under this phase, are listed below:

- Discussions with key stakeholders to understand expectations.
- Review of financial statements, accounting policies, and annual reports, etc.
- Identification of applicable statutes / acts and relationships between various stakeholders, for example power entity and the regulator.

Phase II - Development of Questionnaires and Desktop Reviews

In order to gain an insight into the existing financial reporting and audit related processes and practices followed by the power entities, customized questionnaires were developed and administered. These questionnaires were backed by visits to select SEB locations that included conducting interviews and holding discussion meetings with key process owners at the power entities listed above. The following table presents the level of participation undertaken by the entities in the various states in this process.

States	No. of Entities	Entity Type*	Questionnaire Sent	Questionnaire Received	% Received
Punjab	1	1 S	4	4	100
Rajasthan	5	1G, 1T,3D	15	12	80
Andhra Pradesh	6	1G, 1T, 4D	24	12	50
Orissa	7	2G, 1T, 4D	23	8	35
Uttar Pradesh	4	2G, 1T, 1D	14	7	50
Karnataka	3	2G, 1T	12	4	33
Tamil Nadu	1	1 S	5	4	80
Total	**27**	**2S, 8G, 5T, 12D**	**97**	**51**	**53**

**S=SEB, G=Generation, T=Transmission, D=Distribution.*

This phase also entailed desktop reviews, which covered review and analysis of the financial statements, annual reports, ARR filing, and other related material for the purpose of the study.

Phase III - Collation and Analysis

On receipt of responses to the questionnaires, information was collated, tabulated and analyzed for drawing conclusions on the currently operating procedures followed by the power entities. Based on an understanding of the processes, analysis of responses to the questionnaires and SEB visits, gaps were identified. Good practices and improvements were recommended for redesigning and streamlining the financial reporting related processes.

Phase IV - Discussions and Completion of the Report

The study was discussed with key stakeholders, and their comments were incorporated in the report.

ANNEXURE III **Repeated Audit Qualifications**

Qualifications	Repetition over 3 years	% term	Repetition over 2 years	% term
Proper subsidiary books not maintained	6	24	8	32
Non- compliance with accounting standards				
AS2	6	24	9	36
AS6	10	40	13	52
AS9	4	16	4	16
AS10	6	24	7	28
AS12	5	20	9	36
AS 15	8	32	11	44
Full break up of details under each head and sub-head towards the value of assets and liabilities as per the transfer scheme have not been provided, therefore these balances are subject to adjustments.	5	20	5	20
Inter-Unit Reconciliation not carried out	11	44	14	56
Current Liabilities & Current Liabilities				
None of the balances have been confirmed for sundry. creditors.	9	36	12	48
Fixed assets				
No physical verification carried out	14	56	18	72
Fixed assets register not maintained or is not properly kept.	11	44	15	60
Current Assets & Loans and Advances				
Advances under the head loans and advances have not been reconciled and confirmed, and are long outstanding.	4	16	8	32
Procedure for physical verification of stores is inadequate/not carried out/reports not made available to the auditors.	5	20	9	36
Under/overstatement of stock of material	4	16	6	24
No management system to determine unserviceable stores	8	32	11	44
None of the balances for sundry debtors have been confirmed	7	28	9	36
Bank accounts not reconciled	8	32	10	40
Cash in transit is neither confirmed nor reconciled	4	16	5	20
Other Qualifications				
The internal audit system is not commensurate with the size and nature of the business	13	52	15	60
Internal control procedures are not commensurate with the size of the company and the nature of its business	5	20	8	32
Several accounts under the head capital advances, current liabilities and current assets have not been reconciled	4	16	6	24

ANNEXURE IV List of Accounting Standards issued by the ICAI

	Accounting Standards
AS – 1	Disclosure of accounting policies
AS – 2	Valuation of inventories
AS – 3	Cash flow statements
AS – 4	Contingencies and events occurring after the balance sheet date
AS – 5	Net profit and loss for the period, prior period items, and changes in accounting policies
AS – 6	Depreciation accounting
AS – 7	Accounting for construction contracts
AS – 8	Accounting for research & development
AS – 9	Revenue recognition
AS – 10	Accounting for fixed assets
AS – 11	Accounting for the effects of changes in foreign exchange rates
AS – 12	Accounting for government grants
AS – 13	Accounting for investments
AS – 14	Accounting for amalgamations
AS – 15	Accounting for retirement benefits in the financial statements of employers
AS – 16	Borrowing costs
AS – 17	Segment reporting
AS – 18	Related party transactions
AS – 19	Leases
AS – 20	Earnings per share
AS – 21	Consolidated financial statements
AS – 22	Accounting for taxes on income
AS – 23	Accounting for investments in associates in consolidated financial statements
AS – 24	Discontinuing operations
AS – 25	Interim financial reporting
AS – 26	Intangible assets
AS – 27	Financial reporting of interests in joint ventures
AS – 28	Impairment of assets
AS – 29	Provisions, contingent liabilities and contingent assets

ANNEXURE V Annual Reports Available for Study

✔ Annual reports available	* Annual reports not available	⌛ Books not closed

S.No	Name of Entity	Annual Reports		
		2000-01	2001-02	2002-03
	Punjab			
1	PSEB	✔	✔	✔
	Rajasthan			
2	RRVUNL	✔	✔	✔
3	RRVPNL	✔	✔	✔
4	JVVNL (Jaipur)	✔	✔	✔
5	JVVNL (Jodhpur)	✔	✔	✔
6	AVVNL	✔	✔	✔
	Orissa			
7	OPGCL	✔	✔	✔
8	OHPCL	✔	✔	✔
9	GCOL	✔	✔	*
10	NEESCOL	✔	✔	⌛
11	WESCOL	✔	✔	⌛
12	SESCOL	✔	✔	⌛
13	CESCOL	⌛	⌛	⌛
	Andhra Pradesh			
14	APPGCL	✔	✔	✔
15	TCAPL	✔	✔	✔
16	EPDCAPL	✔	✔	✔
17	SPDCAPL	✔	✔	✔
18	CPDCAPL	✔	✔	✔
19	NPDCAPL	✔	✔	✔
	Karnataka			
20	KPCL	✔	✔	✔
21	KPTCL	✔	✔	✔
22	KREDL	✔	✔	✔
	Tamil Nadu			
23	TSEB	✔	*	*
	Uttar Pradesh			
24	UPRVUNL	✔	✔	✔
25	UPPCL	*	✔	*
26	UPJVNL	✔	✔	*
27	KES	⌛	⌛	⌛

ANNEXURE VI CRISIL Rating Parameters

On an overall basis the weightage used is as follows:

Parameter	Original	Revised
External	**40**	**30**
-State government parameters	20	17
-SERC related parameters	20	13
Internal	**60**	**70**
-Business risk analysis	25	27
Generation	6	6
Transmission & Distribution	19	21
-Financial risk analysis	30	23
Other	**5**	**5**
Progress in attaining commercial viability	NA	**15**

The key aspects evaluated under each of the areas can be summed up as follows:

(a) **State Government**

- Progress in reforming the sector in terms of milestones laid down in the Memorandum of Understanding (MoU) / Memorandum of Agreement (MoA) with MoP.
- Progress in attaining 100 percent rural electrification.
- Track record in terms of subsidy payment.
- Timeliness in release of funds obtained under the APDRP scheme by the respective state government to the utilities.
- Structural adjustment support provided to the sector.
- Success in increasing revenue realization through implementation of anti-theft measures.
- Success in terms of increasing generating capacity, either in the state sector or through creating an enabling environment for private producers.

(b) **State Electricity Regulatory Commission (SERC)**

- Timeliness in terms of issuing tariff orders.
- Actual implementation of tariff orders as well as other directives that may be contained in the order.
- Nature and scope of the tariff order, which would include both tariff and non-tariff issues.

(A negative mark of 2.5 is assigned to states that are yet to set up an SERC.)

(c) **Business Risk Analysis**

- Performance of the power plants in terms of PLF, availability factor, auxiliary power consumption.
- Progress in distribution reforms with respect to key areas like metering all 11 kV feeders, energy audit and increasing the quantum of units billed on a metered basis. Also, the scoring against the energy parameter has been capped at 2.5 out of a maximum of 5 since comprehensive energy audit is possible only after all distribution transformers and consumers are also metered.
- Manpower levels, both absolute compared to normative parameters, as well as their trends, with a negative marking of one in case the trend is adverse.
- Aggregate technical and commercial losses.

(d) **Financial Risk Analysis**

- Coverage of costs through revenues.
- Track record of debt servicing.
- Trends in receivables and power purchase / fuel creditors.
- Progress in terms of funding pension and gratuity liabilities.
- Projected performance over a one-year time horizon.

(e) **Others**

- Current quality of information systems.
- Consistencies in information received.
- Filing with SERC.
- Extent to which the utilities have been able to computerize their systems.

(f) **Progress in Attaining Commercial Viability**

- Gap between ARR and ACS both in absolute and percentage terms. Further ARR is computed on the basis of cash collections since it is cash flows alone that enable an utility to meet operational expenditure, service debt and invest the surplus, if any in modernization and expansion projects.
- Trends in cash loss reduction compared to 2000-01 as base year.

ANNEXURE VII Concept Note on Public Financial Accountability Assessment of State Power Sector Entities (CPN)

I. Introduction

1. The India CAS identifies the power sector as a key sector on the reform agenda linked to India's development priorities. The Bank is heavily engaged in this sector, in terms of both investment and adjustment lending operations. The portfolio of investment projects includes six projects, one each at Orissa, Uttar Pradesh, Rajasthan, and Andhra Pradesh, and two at the center, with overall commitments in the US $ 1.5 billion. Some $ 600 million have been disbursed up to FY 03. Procurement of goods and services constitutes a significant part of these investments.

2. The power sector is a consumer of very large subsidies. Subsidies amount to over Rs 30,000 crore per annum. There are concerns regarding the accounting, internal control, auditing, reporting and scrutiny arrangements - internal and external in relation to generation, transmission and distribution companies across India. The Bank has identified a number of constraints to sector performance. These constraints include poor financial information and weak corporate governance.[37] Efforts have been underway in many states to improve system performance, including unbundling and privatization. The performance of the sector remains below par in many states. Utilities often continue to provide poor service to customers, particularly in the rural areas.[38] Technical and financial losses (example unmetered billings) remain high (estimated at 40–50 %), threatening fiscal stability. There is also lack of transparency regarding such losses and of the activities of some of the entities. Annual financial statements are often late or incomplete. Audit reports are mostly qualified.

3. Entities in the power sector are either statutory bodies (SEBs), or corporatized government owned entities established with the unbundling of the SEBs, GoI owned public sector corporations (NTPC, POWERGRID, NHPC etc.) and some private utilities (Reliance Energy, TATA Power, CESC, private discoms in Orissa, Delhi etc.) under the jurisdiction of the Companies Act, 1956. The SEBs must comply with the reporting requirements of the Electricity Supply Act *and* are expected to comply with specified accounting rules that may be stipulated in the incorporating statute. In this environment, there is a high risk of information asymmetry. The process of public hearing of ARR/tariff issues by the electricity regulators is a positive development over the last few years. It puts the information on costs, subsidies, and operational performance in public domain, thereby putting the appropriate pressures on the entities to improve availability and quality of information.

4. Studies undertaken in the past on the financial viability of the power sector[39] uncovered a number of problems. For example, tariffs are often below expected full cost recovery, operating efficiencies are low, and staffing levels in many utilities are among the highest in the world. For instance, there is increasing awareness of theft, poor billing and collection procedures. The types of remedial action necessary to improve performance have also been highlighted. But sustained progress and results on the ground are not yet evident. One reason may be the insufficient stress

[37] The World Bank, South Asia Energy and Infrastructure Unit, Strategy *Paper*, November 2002.
[38] While over 80percent of villages have electricity, it is estimated that only 35percent of households have access.
[39] Example: (i) 'Restructuring the Power Sector': a study carried out by ICICI for the GoI January 2000 ; and (ii) the 'Study on Accounting in the Power Sector' by the Institute of Chartered Accountants, New Delhi, Research Committee, First edition, April 2002.

laid on the link between sound financial management and accountability and sector-wide performance. Nevertheless, recommendations from these studies have had some positive result. The need for modernization in several areas has been widely acknowledged including accounting and reporting arrangements. A new Electricity Act, 2003 incorporating incentives for performance has recently been approved by Parliament.

5. The ICAI has made efforts to improve the form and content of the accounting and financial reporting arrangements[40] in the sector. Yet, it is widely believed that these functions (including financial reporting) have not been operating satisfactorily at many public sector undertakings (companies and boards) in the sector. There may be systemic issues of financial accounting, accounting policies,[41] reporting, and auditing with significant capacity gaps requiring further attention. These areas would be of likely interest to the sector strategy and dialogue and will also help in building up the FM component in future investment projects.

6. The study looks at issues of public financial accountability with emphasis on "disclosure" from a corporate governance perspective.[42] For instance, do entities provide sufficient information on pension obligations, contingent liabilities, guarantees etc? The overall purpose is to enhance the effectiveness of the system of public financial accountability and management of power sector entities at the state level. This would also entail a limited study of the role of the regulatory bodies and other oversight committees. The emphasis will however be on those aspects of disclosure such as accounting, financial reporting and auditing arrangements that may *not* have been examined in previous studies.

II. Rationale

7. The rationale for undertaking the study is the following:

- The reliability of financial information, especially the audited financial statements of the power sector entities warrants continuing attention of the GoI, state governments and donors. All power companies are required to file annual revenue requirements to the regulator. The returns filed must be based on the books of accounts. Do the "books" provide a sound and consistent basis for measuring entity performance and fair presentation of financial statements?

- The power sector is a major consumer of government *subsidies* - explicit and implicit. State government guarantees can be substantial. The reliability of cost information is a key factor for the decision-making process in the setting of tariffs. Is the regulator satisfied with the quality of financial information provided by the entities?

- A large part of the power sector is in the *public sector* - where corporate governance, financial accountability, transparency arrangements and auditing are widely perceived to be below par.

[40] ICAI has done a study on prevailing accounting standards in the sector and a comparison with national standards.

[41] For example, review of how the accounting practices have evolved on the change from boards, to corporatization to privatization.

[42] The OECD principles of corporate governance recognizes the need for timely and accurate disclosure on all material matters regarding the entity including the financial situation, performance, ownership and governance of the company. Of the 15 elements of corporate governance, set out by consultants at McKinsey, six relate directly to aspects of public financial accountability. These are: board guidelines; board committees such as audit committees; disclosure requirements; accounting standards; independent audit; access to information; and timely disclosure requirements to regulators.

- The *quality of financial information* on power sector entities is a key consideration for investors given the large capital investments involved and higher than necessary recurring technical and financial *losses.*

- Reforms have been undertaken in certain states, such as privatization of distribution companies. The time is right to examine lessons learnt, and assess whether improvements in financial accountability (including reporting and external auditing) and overall performance have ensued. Also, whether they can be demonstrated as *benefits of privatization.*

- Post Enron, the importance of fair presentation of *audited* financial statements has become a *global issue.* Are there any lessons for the Indian power sector? Are there any significant institutional constraints that impact on public financial accountability? Why do most entities have qualified audit opinions?

- Limited information available to the public on the extent to which major public sector undertakings (including electricity boards) are meeting the entities stated objectives.

III. Purpose and Scope

8. The primary purpose of the recommendations will be to inform Bank dialogue [feeding into the Country Assistance Strategy (CAS)] on the need to improve quality and fairness of reporting and overall answerability for the management of public investment in this sector. A key objective is the identification of recommendations aimed at improving the standards and practices associated with sound financial and audit reporting.

9. The scope would cover the *primary* institutions of financial accountability – a thorough study of accounting (both policy and practice), reporting and auditing arrangements (including audit committees) and to a more limited extent related government scrutiny arrangements for public entities. This work will include a *broad* assessment of the entity systems supporting the preparation of timely and reliable financial information.[43]

10. The institutional framework for public accountability will be reviewed. Benchmarking with best practice (from public and /or private sectors) would assist in highlighting areas for further improvement. The backdrop of the corporatization drive in the sector may offer opportunities for identifying areas where adoption of good practice from other jurisdictions may be very useful.

11. The present accounting and auditing regulations demand a C&AG audit of the SEBs under the provisions of the Electricity Supply Act. The C&AG of India appoint the statutory auditor for all government *companies* (majority owned by GoI). . But how effective are these arrangements? Distribution companies (some of which have majority private holding) are audited by private auditors instead of the CAG. As part of this study, we would review the system of appointment of private auditors, including consistency in standards, and determination of their fees.[44] Issues of transition resulting from the move towards privatization should be of interest. Timeliness of financial reporting would be a case in point for comparative performance.

[43] Work on assessment of financial management systems in power utilities has already been done under the Bank's current projects.

[44] The provisions of the Electricity Supply Act prevail wherever the provisions of the Companies Act, 1956 are inconsistent with the Electricity Supply Act.

12. The states of greatest interest would be Uttar Pradesh, Orissa, Karnataka, Andhra Pradesh, Punjab, Tamil Nadu and Rajasthan. There are approximately 29 entities (of which two are statutory entities) operating in these states. In some of these entities, financial losses are being reported; and, in many cases, "up to date" accounts are not readily available, audit reports are qualified, and therefore the a "true and fair" financial position of an entity is difficult to assess conclusively. This, in turn, raises questions regarding the reliability of information for financial management and accountability.

13. Note: Scope exclusions - legislative scrutiny, detailed review of MIS, human resource issues and allegations of corruption in the system.

IV. Methodology

- Review of existing material available at the Bank, consultations with task teams and consultants, including those involved with the study on governance in the power sector in order to develop an appreciation of existing known concerns with audited financial statements and related information and to seek advice on matters of significance.

- Develop a list of all the entities in the sector (public and private) at the concerned states with a profile of the investments involved, ownership, governance arrangements and annual audited financial statements of the individual entities.

- Establish contact points at the governments and entities involved as appropriate, and discuss methodology with officials of the state and the regulator to get input and modify as appropriate.

- Research requirements (including standards and codes) for accounting, disclosure, auditing and public scrutiny; specified in the relevant legislation, regulations, rules, ICAI pronouncements etc.

- Research on what constitutes sound standards, codes and practices relating to accounting, disclosure, auditing, and scrutiny practices in other jurisdictions – national and international in consultation with Organization for Economic Cooperation and Development (OECD) pronouncements etc

- Examine relevant reports based on recent studies on the power sector in India (central and states), including those prepared by other development agencies such as Department for International Development (DFID) and Asian Development Bank (ADB).

- Collect and examine relevant accounting, disclosure, auditing and reports submitted by power sector entities to the boards of directors including audit committees, government, regulator and /or the public.

- Examine whether the above reports meet the requirement of sound practice in the context of good governance and public accountability.

- Hold discussions on the systemic accounting, reporting and auditing issues with the concerned entities in the sector.

Note: A list of specific tasks to be undertaken is enclosed in Attachment 1.

V. Outputs

- Note setting out the results of the study:

  Key PFA issues relating to:

  - The institutional framework for public financial accountability and management in the power sector – with focus on accounting (policy and practice), reporting, auditing and related disclosure policies and practices;
  - The related operating procedures with reference to "sound practice".

- Recommendations for improving Bank dialogue (sector strategy including FM components) on sector-wide performance (feeding into the CAS) in terms of better accounting, reporting and auditing arrangements.

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Attachment

Specific Tasks that will be undertaken:

Effectiveness of Accounting, Disclosure, and Financial Reporting

- To identify and examine the requirements for accounting, disclosure and reporting specified in the legislation, regulations, rules, etc. for their appropriateness in the context of sound financial reporting and transparency.

- To identify the reporting arrangements for the executive, to the regulator, and the public in response to the previous point.

- Assessment of main issues for the Bank relating to accounting, financial reporting and disclosure requirements and institutional arrangements and practices for enhancing reliability of information.

Effectiveness of External Auditing

- To identify and examine the requirements for external auditing specified in the legislation, regulations, rules etc. for their appropriateness.

- To identify the reporting arrangements made by the external auditors to the boards of directors, the executive, and the public in response to the previous point.

- Assessment of the main issues relating to the auditing arrangements in place – external and internal including the effectiveness of audit committees where applicable.

Government Scrutiny

- To identify and examine the arrangements for government scrutiny over the power sector companies including disclosure requirements specified in legislation, regulations, rules etc, for their appropriateness and transparency.

- To determine the extent to which the arrangements such as departmental oversight, internal audit etc. are exercised and effective as a basis for government monitoring and control.

ANNEXURE VIII Questionnaires developed by the World Bank as part of the Study of Financial Accountability Systems of Power Sector Entities in India.

1. **Statutory Audit Questionnaire covers the following aspects:**
   a. Background
   b. Approach
   c. Audit risk
   d. Planning
   e. Internal controls
   f. Execution
   g. Audit report and qualifications
   h. Review by C&AG
   i. Disclosure
   j. Joint auditors

2. **Internal Audit Questionnaire covers the following aspects:**
   a. Overview
   b. Functioning
   c. Internal control
   d. Training
   e. Reporting

3. **Audit Committee Questionnaire covers the following aspects:**
   a. Overview
   b. Composition
   c. Functioning
   d. Roles/responsibilities
   e. Powers
   f. Review of internal control
   g. Statutory audit

4. **Finance Head Committee Questionnaire covers the following aspects:**
   a. Overview
   b. Policies and practices
   c. Training
   d. Computerization
   e. Consolidation of accounts
   f. Financial reporting
   g. Controls
   h. Disclosure

5. **Regulatory Commission Questionnaire covers the following aspects:**
   a. Quality of financial information
   b. ARR filing
   c. Other information received by the regulator from the power entities and needs to be filled by the Chairman/Member of Regulatory Commission.

ANNEXURE IX List of Persons Interviewed

R.S. Mann, Chairman, Punjab State Electricity Regulatory Commission.

Y.C. Satyavadi, Principal Accountant General, C&AG, Punjab.

Surinder Pal, Member, Andhra Pradesh Electricity Regulatory Commission.

R.K. Agarwal, Director, Finance, RRVPNL.

Anand Joshi, Chief Controller of Accounts, RRVPNL.

Shanti Prasad, Member, Rajasthan State Electricity Regulatory Commission.

M.S. Palawat, Chief Controller of Accounts, JVVNL.

M. Sahoo, Joint Secretary, Ministry of Power.

C. Srinivasa Rao, Director, Finance, Central Power Distribution Company of Andhra Pradesh Limited.

Smt. Ajanta Dayalan, Secretary, Punjab State Electricity Regulatory Commissions.

A.K. Agarwal, General Manager, Finance, Punjab State Electricity Board.

S.L. Rao, Chairman, Board of Governors, Institute for Social and Economic Change, Bangalore.

K.S. Menon, Additional Deputy Comptroller and Auditor General of India, Office of the Comptroller and Auditor General (CAG) New Delhi.

Mr. Suresh Prabhu, Member of Parliament (Former Union Minister of Industry, Environment and Forests, Chemical and Fertilizers, Heavy Industries and Public Enterprises and Power).

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